Calendar No. 665

99TH CONGRESS *2d Session*	SENATE	REPORT 99-313

TAX REFORM ACT OF 1986

REPORT

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

TO ACCOMPANY

H.R. 3838

together with

ADDITIONAL VIEWS

[Including cost estimate of the Congressional Budget Office]

MAY 29, 1986.—Ordered to be printed

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99TH CONGRESS
2d Session

SENATE

REPORT
99-313

TAX REFORM ACT OF 1986

MAY 29 (legislative day, MAY 19), 1985—Ordered to be printed

Mr. PACKWOOD, from the Committee on Finance, submitted the following

REPORT

together with

ADDITIONAL VIEWS

[To accompany H.R. 3838]

[Including cost estimate of the Congressional Budget Office]

The Committee on Finance, to which was referred the bill (H.R. 3838) to reform the internal revenue laws of the United States, having considered the same, reports favorably thereon with an amendment in the nature of a substitute to the text and an amendment to the title, and recommends that the bill as amended do pass.

I. LEGISLATIVE BACKGROUND

H.R. 3838 was passed by the House of Representatives on December 17, 1985. It was ordered favorably reported by the Committee on Finance on May 6, 1986, with an amendment in the nature of a substitute, after almost a year-long comprehensive review in the 99th Congress by the Committee on Finance and subcommittees in public hearings and markup consideration. This has been the most extensive review of internal revenue laws since enactment of the 1954 Code.

Committee Hearings

The full committee held 36 days of public hearings on comprehensive tax reform proposals in 1985–1986. The committee began public hearings on comprehensive tax reform proposals on May 9,

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1985. In 1985, committee hearings on tax reform issues were held on June 11–13, 17–20, 25–27; July 9–11, 16–19, 24–25; September 24 and 26; and October 1–4 and 9–10. In 1986, committee hearings were held on January 29–30; February 3–16; March 4; and April 21.

Included in the committee's tax reform hearing consideration this past year was the President's tax reform proposal made in May 1985 ("The President's Tax Reform Proposals to the Congress for Fairness, Growth, and Simplicity").

Subcommittee Hearings

Several Subcommittee hearings were held during 1985 and 1986 that relate to subject matters included in H.R. 3838, as amended by the Committee on Finance.

Subcommittee on Savings, Pensions, and Investment Policy.—The Savings, Pensions, and Investment Policy Subcommittee held hearings on the following areas:

September 9, 1985—Post-retirement health benefits
November 22, 1985—Targeted jobs tax credit extension
January 28, 1986—Retirement Income Policy Act

Subcommittee on Energy and Agricultural Taxation.—The Energy and Agricultural Taxation Subcommittee held a hearing on the following area:

June 21, 1985—Impact of taxation on energy policy

Subcommittee on Health.—The Health Subcommittee held a hearing on the following area:

September 9, 1985—Asbestos-related disease trust fund

Subcommittee on Taxation and Debt Management.—The Taxation and Debt Management Subcommittee held a hearing on the following area:

January 31, 1986—Mortgage-backed securities

Committee Markup

The committee conducted 17 days of markup on the tax reform bill: beginning on March 19, 1986; continuing on March 24–26, April 8–10, 14–18, 22, 24, 28, and May 5; and concluding on May 6, when the tax reform bill, H.R. 3838, as amended,* was ordered favorably reported by a unanimous vote (20–0).

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* References in this Report to "the bill" are to the committee amendment to H.R. 3838, which is reported in the nature of a substitute to H.R. 3838 as passed by the House of Representatives.

II. GENERAL REASONS FOR THE BILL

Overview

The committee bill represents one of the most fundamental reforms of the Federal income tax system since its introduction in 1913. After nearly a year of hearings, the committee concluded that only the most thorough reform could assure a simpler, fairer, and more efficient tax system which could regain the trust of the American people.

The committee bill sets forth a number of sweeping changes to the present system. First, the committee desires a simpler tax system for individuals. The bill provides just two individual income tax rates—15 percent and 27 percent—to replace more than a dozen tax rates in each of the present-law rate schedules which extend up to 50 percent. Significant increases in the standard deduction and restrictions on certain personal deductions will provide further simplicity by greatly reducing the number of taxpayers who would itemize their deductions.

Second, the committee desires a fairer tax system. It is difficult for the committee to find fairness in a tax system that allows some high-income individuals to pay far lower rates of tax than other, less affluent individuals. The committee bill provides strict new limitations on the use of losses from passive investments to shelter other types of income and expands the minimum tax to prevent these tax inequities in the future. The committee bill also provides significant reductions in the tax burden of the working poor and removes six million low-income individuals from the tax roll.

Third, the committee seeks a more efficient tax system. The current tax system intrudes at nearly every level of decision-making by businesses and consumers. The sharp reductions in personal and corporate tax rates and the elimination of many preferences will directly remove or lessen tax considerations in business and consumption decisions. Businesses will be able to compete on a more equal basis, and business winners will be determined more by serving the changing needs of a dynamic economy, and less by reaping the subsidies provided by the tax code.

Simplicity

The present tax system is far from simple. April 15 is a date feared by many individuals not because they are unwilling to provide the revenues needed for necessary government activities, but because of the recordkeeping, paperwork, and computations necessitated by tax filing. Many taxpayers feel they must rely on paid tax preparers in order to calculate accurately their tax liability. The complexity faced by other taxpayers has helped spawn a thriving tax shelter industry whose sole purpose is to reduce tax liability by making use of special tax provisions and by engaging in so-

phisticated financial arrangements. The cost of complying with all of the requirements of the income tax is estimated to total 5 to 10 percent of the tax actually paid. Simplification of the tax code is, itself, a form of tax reduction.

The committee bill will reduce significantly the complexity of the tax code for most Americans. There will be only two individual tax brackets, and over 80 percent of all individual taxpayers will pay no tax or at a marginal rate no higher than 15 percent.

As a result of significant increases in the standard deduction, the number of itemizers is estimated to decline by one-third under the committee bill. These taxpayers who use the standard deduction rather than itemizing will be freed from much of the recordkeeping, paperwork, and computations that currently are required.

Other individuals who presently expend a great amount of time and resources to find investments that reduce their tax liability also will benefit from tax simplification. Currently, many of these investments yield no current economic profit, but are valuable for the paper losses they create. With the significant rate reductions achieved by this bill, many taxpayers will find such investments unnecessary, and will choose less complex and more productive investments.

Some taxpayers who attempt to use various preferences to reduce their tax liability significantly may find that the bill does not simplify the tax filing process for them as much as for other individuals. In part, the complexity of the tax system for these individuals is needed to measure accurately their income and to ensure that these individuals pay a rate of tax appropriate for their income.

Fairness

A primary goal of the committee is to provide a tax sysem that ensures that individuals with similar incomes pay similar amounts of tax. The ability of some individuals to reduce their tax liability excessively leads to a direct erosion of the tax base, requiring higher tax rates. Other individuals unable to take advantage of tax shelters may lose confidence in the tax system and may respond by seeking to evade their tax liability.

The committee has adopted a significant new provision which directly restricts the use of tax shelter losses to offset unrelated income. Further, a strengthened minimum tax prevents the elimination of substantial income tax liability through the excessive use of preferences. Given these restrictions and the elimination of other preferences, the dramatic reduction in the top tax rate from 50 percent to 27 percent can be achieved while maintaining the distribution of the tax burden.

The committee believes that as a result of the large reductions in tax rates, it is no longer necessary to provide a lower rate for capital gains income of individuals. Eliminating the preferential treatment of capital gains income, and thereby eliminating the incentive to recharacterize certain income in order to qualify for capital gains treatment, will eliminate the abuse of this provision and greatly reduce the complexity of the tax system for many individuals.

The committee bill retains the most widely utilized itemized deductions, including deductions for home mortgage interest, State and local income taxes, real estate and personal property taxes, charitable contributions, casualty and theft losses, and medical expenses (above an increased floor). Other deductions which benefit a limited number of taxpayers, add complexity to tax filing, or are subject to abuse are restricted. For example, the requirements for deducting business meals are tightened and only 80 percent of business meals and entertainment expenses are deductible under the bill. Certain abuses such as the deduction for attending investment seminars and for "educational" travel costs are eliminated. These expenditures differ little from other personal consumption expenditures, which generally are not deductible.

The committee bill disallows the itemized deductions for State and local sales taxes and interest deductions for other than a first or second home mortgage. The committee believes these deductions introduce unnecessary complexity and encourage consumption at the expense of savings.

Certain items of compensation that are similar to taxable compensation are no longer excluded from income under the bill. For example, the partial exclusion for unemployment compensation is repealed, and certain prizes and awards are taxable. The ability of high-income families to take advantage of the graduated rate structure by transferring investment property to their minor children and thus sheltering their investment earnings at their children's lower tax rates also is restricted.

The committee bill makes numerous changes to increase employee eligibility for pension benefits. The bill expands the rules requiring coverage of a broad group of employees under an employer-maintained retirement plan, reduces from 10 years to 5 years the maximum time an employee must work for a given employer before becoming vested, and eliminates the ability of employers to offset completely the pension benefits of low-paid workers by the amount of their social security benefits. The committee bill also reduces the limitations on annual elective deferrals to qualified cash or deferred arrangements (sec. 401(k) plans), and provides tighter nondiscrimination tests to ensure that such plans do not disproportionately benefit highly compensated employees.

The committee believes that the present tax treatment of individual retirement accounts (IRAs) is unnecessarily generous for individuals who participate in other tax-favored retirement arrangements, and the bill eliminates the deduction for contributions to an IRA for such individuals. The bill permits these individuals, however, to make nondeductible contributions to an IRA and to defer taxes on the earnings of these contributions. The committee believes that the lower tax rates provided by the bill, which will themselves stimulate additional work effort and saving, eliminate the need for this special deduction for these individuals. To ensure universal availability of tax-favored retirement arrangements, the bill retains the present-law deduction for individuals unable to participate in other plans.

In addition to ensuring that high-income taxpayers pay their share of the Federal tax burden, the committee bill provides tax relief to low-income wage earners. To achieve this goal, the com-

mittee bill substantially increases the standard deduction (the present-law zero bracket amount) and nearly doubles the personal exemption to $2,000. Together with the greatly expanded earned income credit, these provisions will relieve approximately six million low-income individuals from tax liability and will ensure that no families below the poverty level will have Federal income tax liability. The child care credit is preserved to assist working parents with their dependent care expenses.

The elderly and blind also receive tax relief under the bill. Although they would no longer qualify for an extra personal exemption, a special $600 standard deduction, effective for 1987, is provided for these taxpayers in addition to the increased standard deduction and personal exemption provided for all taxpayers. The present-law credit for elderly individuals and for individuals who are permanently and totally disabled also is retained.

Tax fairness also requires that corporate taxpayers pay amounts of tax appropriate for their level of earnings. The committee finds it unjustifiable for some corporations to report large earnings and pay significant dividends to their shareholders, yet pay little or no taxes on that income to the government. The committee has designed a strong alternative minimum tax for corporations, based on a broad tax base, to prevent corporations from significantly reducing their tax liability. A unique feature of this alternative minimum tax is the inclusion of a corporation's book income in the tax base used for this computation.

The committee bill makes several accounting changes to provide more accurate matching between the recognition of income and deductions for expenditures related to this income. Use of the installment method is restricted and certain costs of inventory and self-constructed assets are capitalized under the bill. Similarly, the committee bill alters the taxation of property and casualty insurance companies to account better for timing differences to measure income more accurately.

The taxation of foreign income also is modified to restrict opportunities to use passive financial transactions to reduce tax liability on U.S. income, while not hindering the international competitiveness of U.S. firms. In addition, the bill provides more equitable taxation of foreign investment in the United States.

Together with other changes made by the bill, the aggregate corporate tax liability is estimated to increase by approximately $100 billion between fiscal years 1986 and 1991, while individual taxes are reduced by a similar amount. Even with these changes, the share of total income tax receipts paid by corporations will remain below pre-1980 levels.

The committee also believes it is important to maintain the trust of honest taxpayers in the tax system by ensuring that other taxpayers cannot illegally evade their tax liability. The committee bill provides for significant increases in the Internal Revenue Service budget for agents, audits, and the modernization of compliance systems. These budget increases are made possible by the establishment of a unique IRS trust fund, funded through penalties for noncompliance and interest on underpayments of tax.

Efficiency

The committee's most important steps in promoting the efficiency of the economy and in reducing the interference of the tax system are the dramatic reductions in personal and corporate tax rates. Lower marginal tax rates stimulate work effort and saving by leaving more of each additional dollar earned in the hands of the taxpayer. Further, lower tax rates reduce the value of tax deductions, causing investment and consumption decisions to be chosen more on the basis of their economic merits, and less on the value of the tax benefits associated with them.

The present Federal tax system contains a number of tax preferences, which have not satisfactorily served the purposes for which they were designed. In the past few years, tax incentives have led to the excessive construction of office buildings and record vacancy rates; overinvestment in agriculture tax shelters by high-income investors with little knowledge of farming; and distortions at all levels of business—from financing choices to production decisions.

The committee desires to make the tax treatment of diverse economic activity more even. Equitable taxation promotes the efficient allocation of investment and yields productivity gains without requiring additional saving. The committee bill repeals the investment tax credit, which discriminated against long-lived investment and was often used as a tax shelter device. The incentive for investment provided by the credit instead will be provided by lower tax rates and accelerated depreciation.

The committee bill preserves and generally liberalizes for most equipment the present-law Accelerated Cost Recovery System. To offset in part the loss of the investment credit, the rate of depreciation is accelerated for most equipment. The depreciation period of certain assets, such as real property and long-lived equipment, is lengthened to reflect more closely their actual useful life. The committee believes these changes help provide a more efficient capital cost recovery system.

The lower tax rates provided by the committee bill also reduce financing inefficiencies. High marginal tax rates favor debt financing over equity financing, due to the deductibility of interest payments. This creates an incentive for highly leveraged takeovers and leaves firms vulnerable to severe financial stress.

The committee bill also adopts reforms affecting the availability of tax-exempt financing. The committee recognizes the efficiencies of allowing joint public-private partnerships in the provision of government services and has liberalized management contract rules for government facilities. At the same time, the committee bill restricts tax-exempt financing for fundamentally private activities.

The committee bill generally preserves present law for natural resources, and retains a number of business incentives that the committee believes to be beneficial to the economy. The research and development tax credit, which expired at the end of 1985, is extended for four additional years at a 25-percent rate. The benefits to society of research are frequently greater than the compensation received by those undertaking the risks of research. Extending the R&D credit helps ensure that adequate amounts of re-

search are undertaken. Certain expired business energy tax credits also are temporarily extended by the bill, though at reduced rates.

The bill provides a new tax credit for low-income rental housing to consolidate the uncoordinated subsidies under present law. The credit is better targeted to low-income individuals than provisions under present law, and requires that tenants' rents are limited to affordable amounts in relation to their incomes. The committee bill also preserves rehabilitation tax credits for historic and pre-1936 structures at a reduced rate. The credit has been found to be useful in revitalizing depressed urban areas and in preserving America's architectural past for future generations.

In conclusion, the committee believes that this tax reform bill provides a simpler, fairer, and more efficient tax system. The changes made by this bill represent a historic reform of the Federal income tax structure. By guaranteeing individuals and corporations much lower tax rates, the need for special tax preferences is greatly diminished. The bill eliminates needless interference with economic activity and establishes the framework for a growing and productive economy.

III. BUDGET EFFECT OF THE BILL

Tables III–1 and III–2, following, present estimated budget effects of the committee bill for fiscal years 1986–1991. Each of the tables gives amounts by title of the bill and by effect on individual, corporate, excise, employment, and estate and gift tax receipts (and outlays). Table III–2 shows more detailed estimates by provision within each title.

Over the six-year period, 1986–1991, the committee tax reform bill is estimated to be close to neutral, with a negative net budget effect of $952 million (or by less than 0.1 percent of total estimated tax revenues) over the six-year period.

Table III-1.—Summary of Estimated Budget Effects of H.R. 3838, as Reported by the Committee on Finance, Fiscal Years 1986-1991

[Millions of dollars]

Title of Bill	1986	1987	1988	1989	1990	1991	1986-91
I. Individual Income Tax Provisions							
Individual		−12,242	−64,041	−65,653	−56,627	−58,069	−256,632
Corporate		652	1,109	1,263	1,474	1,628	6,126
Total		11,590	−62,932	−64,390	−55,153	−56,441	−250,506
II. Accelerated Cost Recovery System and Investment Tax Credit							
Individual	856	4,315	3,212	4,268	5,913	8,024	26,588
Corporate	7,398	18,377	17,017	22,464	28,724	36,767	130,747
Total	8,254	22,692	20,229	26,732	34,637	44,797	157,335
III. Accounting Provisions							
Individual		300	806	897	894	822	3,719
Corporate		7,238	11,188	10,918	10,489	10,126	49,959
Total		7,538	11,989	11,815	11,383	10,948	53,673
IV. Capital Gains & Losses							
Individual		(1)	(1)	(1)	(1)	(1)	(1)

V. Compliance and Tax Administration							
Individual		3,003	3,645	2,925	3,025	3,389	15,997
Corporate		817	1,989	2,750	3,069	3,335	11,960
Excise		4	4	4	4	4	20
Estate and Gift		4	4	4	4	4	20
Total		3,828	5,642	5,683	6,112	6,732	27,997
VI. Corporate and General Business Taxation							
Individual		−673	1,709	639	980	850	3,505
Corporate	−15	−7,616	−22,204	−30,025	−32,052	−33,355	−125,267
Employment		−561	−223	−35	78	−37	−778
Excise		(4)	68	75	82	90	315
Total	−15	−8,850	−20,650	−29,346	−30,912	−32,452	−122,225
VII. Agriculture, Energy, and Natural Resources							
Individual		10	34	14	13	16	87
Corporate	−152	−216	−71	26	38	27	−348
Employment		−15	−21	−24	−27	−29	−116
Excise	(2)	(2)	(2)	(2)	(2)	(2)	(3)
Customs		(4)	(4)	(4)	(4)	(4)	(3)
Total	−152	−221	−58	16	24	14	−377
VIII. Financial Institutions							
Individual	−3	−1	−1	−1	−1	−1	−7
Corporate		55	28		16	49	148
Total		52	27	−1	15	48	141

Table III–1.—Summary of Estimated Budget Effects of H.R. 3838, as Reported by the Committee on Finance, Fiscal Years 1986–1991—Continued

[Millions of dollars]

Title of Bill	1986	1987	1988	1989	1990	1991	1986–91
IX. Foreign Tax Provisions							
Individual		24	34	45	56	61	220
Corporate		431	759	841	957	1,068	4,056
Total		455	793	886	1,013	1,129	4,276
X. Insurance Products and Companies							
Individual		(4)	(4)	(4)	(4)	(4)	(3)
Corporate		1,059	1,968	2,052	2,144	2,163	9,386
Total		1,059	1,968	2,052	2,144	2,163	9,386
XI. Minimum Tax Provisions							
Individual		426	2,002	1,645	1,225	1,211	6,539
Corporate		3,877	6,947	7,207	7,318	7,979	33,328
Total		4,303	8,949	8,852	8,573	9,190	39,867
XII. Pensions and Deferred Compensation; Employee Benefits; ESOPs							
Individual		1,908	6,222	7,620	9,382	10,534	35,666
Corporate		1,101	955	269	117	40	2,482
Excise		−10	−10	30	30	30	70
Employment		−130	−112	−144	−166	−177	−729
Total		2,869	7,055	7,775	9,363	10,427	37,489

XIII. Research and Development							
Individual	−32	−91	−104	−118	−92	−23	−460
Corporate	−616	−1,733	−1,772	−1,735	−1,238	−654	−7,748
Total	−648	−1,824	−1,876	−1,853	−1,330	−677	−8,208
XIV. Tax Shelters; Interest Expense; Real Estate							
Individual		2,108	10,224	13,738	17,356	18,823	62,249
Corporate		−605	−2,276	−3,000	−3,552	−3,521	−12,954
Total		1,503	7,948	10,738	13,804	15,302	49,295
XV. Tax-Exempt Bonds							
Individual		−23	−127	−317	−475	−557	−1,499
Corporate		−2	−13	−29	−47	−65	−156
Total		−25	−143	−353	−533	−637	−1,691
XVI. Taxation of Trusts and Estates; Income of Minor Children; Estate and Gift Taxes							
Individual		1,727	841	602	645	694	4,509
Estate and Gift		−105	−26	(3)	(3)	(3)	−131
Total		1,622	815	602	645	694	4,378
XVII. Miscellaneous Tax Provisions							
Individual	−9	−48	−68	−29	−19	−28	−201
Corporate	−35	−163	−303	−252	−180	−152	−1,085
Total	−44	−211	−371	−281	−199	−180	−1,286

Table III–1.—Summary of Estimated Budget Effects of H.R. 3838, as Reported by the Committee on Finance, Fiscal Years 1986–1991—Continued

[Millions of dollars]

Title of Bill	1986	1987	1988	1989	1990	1991	1986–91
XVIII. Technical Corrections							
Individual		−180	−24	−25	−27	−31	−287
Corporate		−206	−99	34	34	28	−209
Total		−386	−123	9	7	−3	−496
Totals:							
Individual	815	561	−35,636	−33,750	−17,712	−14,295	−100,007
Corporate	5,580	23,066	15,214	12,776	17,300	25,448	100,384
Excise		−6	−62	109	116	124	405
Employment		−706	−356	−203	−115	−243	−1,623
Estate and Gift		−101	−225	4	4	4	111
Customs		(4)	(4)	(4)	(4)	(4)	(3)
Grand Total	7,395	22,814	−20,738	−21,064	−407	11,048	−952

[1] The effects of changes relating to capital gains are included with rate changes in Title I.
[2] Loss of less than $5 million.
[3] Amounts have not been assigned to footnotes for summation purposes. Therefore, totals do not include estimates represented by footnotes.
[4] Gain of less than $5 million.

Table III-2.—Estimated Budget Effects of H.R. 3838, as Reported by the Committee on Finance, Fiscal Years 1986–1991

[Millions of dollars]

Title and Provision	1986	1987	1988	1989	1990	1991	1986–91
I—Individual Income Tax Provisions							
Rate reductions [1]		−2,511	−52,885	−47,743	−36,715	−35,971	−175,825
Increase in standard deduction		−1,104	−5,869	−7,971	−8,731	−9,565	−33,240
Personal exemption increase		−13,127	−26,170	−27,083	−29,146	−31,332	−126,858
Repeal second earner deduction		1,428	6,108	5,848	6,217	6,609	26,210
Increase the earned income tax credit [2]		−53	−1,576	−3,942	−4,490	−5,062	−15,123
Repeal income averaging		436	1,855	2,017	2,170	2,333	8,811
Taxation of unemployment compensation		235	775	749	723	701	3,183
Taxation of prizes and awards		−19	−52	−55	−58	−61	−245
Repeal sales tax deduction		714	4,621	3,867	4,045	4,232	17,479
Increase medical expense deduction floor		350	2,313	2,225	2,305	2,388	9,581
Housing allowances for clergy and military personnel		[3]	[3]	[3]	[3]	[3]	[4]
Limitations on deductions for meals, travel, and entertainment							
Individual		556	934	1,054	1,231	1,359	5,134
Corporate		652	1,109	1,263	1,474	1,628	6,126
Miscellaneous itemized deductions; employee business expense		853	5,578	5,040	5,468	5,932	22,871
Repeal political contributions tax credit			327	341	354	368	1,390
Subtotal, Individual Income Tax							
Individual		**−12,242**	**−64,041**	**−65,653**	**−56,627**	**−58,069**	**−256,632**
Corporate		**652**	**1,109**	**1,263**	**1,474**	**1,628**	**6,126**
Total		**−11,590**	**−62,932**	**−64,390**	**−55,153**	**−56,441**	**−250,506**
II—ACRS and ITC							
Depreciation, expensing							
Individual		−153	−404	−273	337	1,557	1,064
Corporate		−879	−2,311	−2,231	−158	4,017	−1,562
Investment tax credit							
Individual	856	4,468	3,616	4,541	5,576	6,467	25,524

Table III-2.—Estimated Budget Effects of H.R. 3838, as Reported by the Committee on Finance, Fiscal Years 1986-1991—Continued

[Millions of dollars]

Title and Provision	1986	1987	1988	1989	1990	1991	1986-91
Corporate	7,398	19,256	19,195	24,340	28,407	32,281	130,877
Repeal finance leasing							
Corporate			133	355	475	469	1,432
Subtotal, ACRS and ITC							
Individual	**856**	**4,315**	**3,212**	**4,268**	**5,913**	**8,024**	**26,588**
Corporate	**7,398**	**18,377**	**17,017**	**22,464**	**28,724**	**36,767**	**130,747**
Total	**8,254**	**22,692**	**20,229**	**26,732**	**34,637**	**44,797**	**157,335**
III—Accounting Provisions							
Limitation on the use of cash accounting							
Individual			−10				−10
Corporate		79	166	177	181	189	792
Require utilities to accrue earned but unbilled income							
Corporate		191	356	384	387	200	1,518
Recognition of gain on pledges of installment obligations							
Individual		19	50	36	36	37	178
Corporate		1,272	1,663	1,345	1,358	1,395	7,032
Capitalization of inventory, construction, and development costs							
Individual		178	473	576	607	610	2,444
Corporate		4,785	7,593	7,690	7,239	7,025	34,332
Repeal of reserve for bad debt for nonfinancial institutions							
Individual		31	89	82	83	83	368
Corporate		842	1,291	1,232	1,243	1,244	5,852
Qualified discount coupons							
Corporate		13	25	28	29	30	125
Discharge of indebtedness							
Individual		2	4	3	3	2	14

Corporate	57	79	62	52	43	293
Partnership, Sub S, and personal service tax year conformity						
Individual	70	200	200	165	90	725
Subtotal, Accounting	**300**	**806**	**897**	**894**	**822**	**3,719**
Individual	**7,238**	**11,178**	**10,918**	**10,489**	**10,126**	**49,959**
Corporate						
Total	**7,538**	**11,984**	**11,815**	**11,383**	**10,948**	**53,673**
IV—Capital Gains and Losses						
Capital gains						
Individual	(1)	(1)	(1)	(1)	(1)	(1)
Incentive stock options						
Individual	(3)	(3)	(3)	(3)	(3)	(4)
Tax straddles						
Individual	(8)	(8)	(8)	(8)	(8)	(4)
Subtotal, Captial Gains						
Individual	(4)	(4)	(4)	(4)	(4)	(4)
V—Compliance and Tax Administration [5]						
Penalty provisions and voluntary disclosure						
Individual	447	319	336	341	346	1 789
Corporate	61	117	140	138	137	593
Estate and gift	4	4	4	4	4	20
Excise	4	4	4	4	4	20
Interest provisions [7]						
Individual	95	193	164	163	210	825
Corporate	202	311	204	262	344	1,323
Information reporting provisions						
Individual	68	317	488	623	648	2,144
Corporate	(8)	70	5	5	(8)	80
Tax shelter provisions						
Individual	15	88	54	(8)	(8)	157
Revised estimated tax rules						
Individual	1,385	75	44	104	80	1,688
IRS Trust Fund [6]						
Individual	993	1,346	1,778	1,627	1,910	7,654
Corporate	554	1,491	2,401	2,664	2,854	9,964

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Table III-2.—Estimated Budget Effects of H.R. 3838, as Reported by the Committee on Finance, Fiscal Years 1986-1991—Continued

[Millions of dollars]

Title and Provision	1986	1987	1988	1989	1990	1991	1986-91
Employee withholding schedule							
Individual			1,307	61	177	195	1,740
Subtotal, Compliance and Tax Administration							
Individual		**3,003**	**3,645**	**2,925**	**3,035**	**3,389**	**15,997**
Corporate		**817**	**1,989**	**2,750**	**3,069**	**3,335**	**11,960**
Excise		**4**	**4**	**4**	**4**	**4**	**20**
Estate & Gift		**4**	**4**	**4**	**4**	**4**	**20**
Total		**3,828**	**5,642**	**5,683**	**6,112**	**6,732**	**27,997**
VI—Corporate and General Business Taxation							
Corporate rate reductions							
Corporate		−8,092	−22,880	−30,591	−32,564	−33,854	−127,981
Dividends received deduction							
Corporate		139	217	218	236	254	1,064
Dividend exclusion							
Individual		228	604	607	673	748	2,860
NOL provisions							
Corporate		18	45	49	49	49	210
Extraordinary dividends							
Corporate		30	50	53	55	58	246
Basis allocation							
Individual		−2	2	9	13	16	38
Corporate		60	53	56	61	64	294
Amortization of trademarks and tradenames							
Individual		1	4	8	14	20	47
Corporate		3	9	17	27	37	93
Bus operating authorities							
Corporate	−15	−5					−20
Credit limitations							
Corporate		231	302	173	84	37	827

Regulated investment companies							
Individual		(8)	1,395	116	128	140	1,779
Excise		(8)	68	75	82	90	315
Federal tax deposit threshold							
Individual		−900	−296	−101	152	−74	−1,219
Employment		−561	−223	−35	78	−37	−778
Subtotal, Corporate and General Business							
Individual		**−673**	**1,709**	**639**	**980**	**850**	**3,505**
Corporate	**−15**	**−7,616**	**−22,204**	**−30,025**	**−32,052**	**−33,355**	**−125,267**
Employment		**−561**	**−223**	**−35**	**78**	**−37**	**−778**
Excise		**(8)**	**68**	**75**	**82**	**90**	**315**
Total	**−15**	**−8,850**	**−20,650**	**−29,346**	**−30,912**	**−32,452**	**−122,225**
VII—Agriculture, Energy, and Natural Resources							
Repeal expensing of conservation and field clearing expenditures							
Individual		9	26	24	24	23	106
Corporate		8	12	11	11	11	53
Prepayments							
Individual		11	24	8	9	11	63
Discharge of farm indebtedness							
Individual		−9	−10	−8	−7	−5	−34
Special rule for expenses incurred in replanting							
Individual		−1	−6	−10	−13	−13	−43
Energy credits and related incentives							
Individual		(8)	(8)	(8)	(8)	(8)	(4)
Corporate	−152	−228	−89	10	22	15	−422
Excise	(3)	(3)	(3)	(3)	(3)	(3)	(4)
Customs		(8)	(8)	(8)	(8)	(8)	(4)
Foreign IDCs and mining exploration costs							
Corporate		4	6	5	5	1	21
Conservation easement donations							
Individual		(3)	(3)	(3)	(3)	(3)	(4)
FUTA provisions for agricultural wages							
Employment		−15	−21	−24	−27	−29	−116
Subtotal, Energy, Agriculture, Timber, and Natural Resources							
Individual		**10**	**34**	**14**	**13**	**16**	**87**

Table III–2.—Estimated Budget Effects of H.R. 3838, as Reported by the Committee on Finance, Fiscal Years 1986–1991—Continued

[Millions of dollars]

Title and Provision	1986	1987	1988	1989	1990	1991	1986–91
Corporate	−152	−216	−71	26	38	27	−348
Employment		−15	−21	−24	−27	−29	−116
Excise	(3)	(3)	(3)	(3)	(3)	(3)	(4)
Customs		(3)	(3)	(3)	(3)	(3)	(4)
Total	−152	−221	−58	16	24	14	−377
VIII—Financial Institutions							
Limitation on bad debt reserves							
Corporate		55	90	98	113	130	486
Special carryover NOL carryover rules for depository institutions							
Corporate			−62	−98	−97	−81	−338
Treatment of losses on deposits in insolvent financial institutions							
Individual		−3	−1	−1	−1	−1	−7
Subtotal, Financial Institutions							
Individual		−3	−1	−1	−1	−1	−7
Corporate		55	28	(3)	16	49	148
Total		52	27	−1	15	48	141
IX—Foreign Tax Provisions							
Separate limitation for passive income							
Corporate		259	422	410	437	467	1,995
Separate limitation for high taxed interest income							
Corporate		85	152	149	149	148	683
Deemed-paid credit							
Corporate		6	20	60	86	97	269
Limitation on special treatment of 80–20 corporations							
Corporate		(3)	(3)	(3)	(3)	(3)	(4)

Transportation income						
Corporate	8	16	18	25	30	97
Allocation of interest and other expenses						
Corporate	61	130	185	231	279	886
Source rule for space and certain ocean activities						
Corporate	(5)	(5)	(5)	(5)	(5)	(4)
Tax haven (subpart F) income						
Corporate	25	41	41	44	49	200
Threshold for imposition of current tax under subpart F						
Corporate	(5)	(5)	(5)	(5)	(5)	(4)
De minimis tax haven income rule						
Corporate	12	22	24	26	29	113
Possessions tax credit						
Corporate	27	45	45	50	54	221
Reduce foreign earned income (sec. 911) exclusion						
Individual	24	34	45	56	61	220
Foreign investment companies						
Corporate	10	17	16	18	20	81
Branch profits tax						
Corporate	13	20	23	26	28	110
Income of foreign governments						
Corporate	23	43	48	53	58	225
Dual resident companies						
Corporate	24	41	43	46	49	203
Interest paid to related tax-exempt parties						
Corporate	12	26	27	29	33	127
Foreign investment in U.S. business assets						
Corporate	−134	−236	−248	−263	−273	−1,154
Foreign currency gain or loss						
Corporate	(5)	(5)	(5)	(5)	(5)	(4)
Subtotal, Foreign Tax Provisions						
Individual	**24**	**34**	**45**	**56**	**61**	**220**
Corporate	**431**	**759**	**841**	**957**	**1,068**	**4,056**
Total	**455**	**793**	**886**	**1,013**	**1,129**	**4,276**
X—Insurance Products and Companies						
Insurance policy holders						
Individual	(5)	(5)	(5)	(5)	(5)	(4)

Table III-2.—Estimated Budget Effects of H.R. 3838, as Reported by the Committee on Finance, Fiscal Years 1986-1991—Continued

[Millions of dollars]

Title and Provision	1986	1987	1988	1989	1990	1991	1986-91
Life insurance company provisions							
Corporate		391	678	729	783	839	3,420
Property and casualty insurance provisions							
Corporate		668	1,290	1,323	1,361	1,324	5,966
Subtotal, Insurance Products and Companies							
Individual		(5)	(5)	(5)	(5)	(5)	(5)
Corporate		1,059	1,968	2,052	2,144	2,163	9,386
Total		1,059	1,968	2,052	2,144	2,163	9,386
XI—Minimum Tax Provisions							
Revise the alternative minimum tax							
Individual		426	2,002	1,645	1,255	1,211	6,539
Revise corporate minimum tax							
Corporate		3,877	6,947	7,207	7,318	7,979	33,328

Table III-2.—Estimated Budget Effects of H.R. 3838, as Reported by the Committee on Finance, Fiscal Years 1986-1991—Continued

[Millions of dollars]

Title and Provision	1986	1987	1988	1989	1990	1991	1986-91
Subtotal, Minimum Tax							
Individual		**426**	**2,002**	**1,645**	**1,255**	**1,211**	**6,539**
Corporate		**3,877**	**6,947**	**7,207**	**7,318**	**7,979**	**33,328**
Total		**4,303**	**8,949**	**8,852**	**8,573**	**9,190**	**39,867**
XII—Pension and Deferred Compensation; Employee Benefits; ESOPS							
Individual retirement arrangements (IRAs)							
Individual		1,697	5,186	5,715	6,207	6,704	25,509
Qualified cash or deferred arrangements (401(k))							
Individual		190	344	304	300	317	1,455
Repeal exclusion of current annuity income of corporations							
Corporate		3	13	31	48	65	160
Simplified employee plans (SEPs)							
Individual		−15	−29	−28	−33	−37	−142
Minimum standards for qualified plans							
Individual		(3)	(3)	(3)	(3)	(3)	(4)
Uniform distribution requirements							
Individual		(3)	(3)	(3)	(3)	(3)	(4)
Excise			(3)	(3)	(3)	(3)	(4)
Tax on pre-retirement distributions							
Individual		47	158	295	411	550	1,461
Replace 10-year averaging with limited 5-year averaging							
Individual		92	48	18	27	38	223
Repeal 3-year basis recovery rule for contributory plans							
Individual			48	829	1,925	2,316	5,118

Loan provisions						
Individual	(5)	(5)	(5)	(5)	(5)	(4)
Increase early retirement age with true actuarial reduction						
Individual	315	869	960	1,097	1,259	4,500
Adjustments to Sec. 404 limitations						
Individual	17	42	45	49	54	207
Tax on qualified plan reversions						
Excise	−10	−10	30	30	30	70
Extension of the exclusion for group legal plans						
Individual	−116	−116	−153	−179	−186	−750
Employment	−51	−60	−84	−100	−103	−398
Extension of the exclusion for education assistance						
Individual	−130	−91	−102	−115	−126	−564
Employment	−79	−52	−60	−66	−74	−331
Self-employed health insurance						
Individual	−255	−348	−373	−424	−481	−1,881
Discrimination rules for employee benefits						
Individual	66	116	128	140	154	604
Limitation on accrual of vacation pay						
Individual	5	8	2	2	2	19
Corporate	85	63	17	18	15	198
Faculty housing						
Individual	(3)	(3)	(3)	(3)	(3)	(4)
Health benefits for retirees						
Individual	−5	−13	−20	−25	−30	−93
Changes related to ESOPs						
Corporate	1,013	879	221	51	−40	2,124
Subtotal, Pensions and Employee Benefits						
Individual	**1,908**	**6,222**	**7,620**	**9,382**	**10,534**	**35,666**
Corporate	**1,101**	**955**	**269**	**117**	**40**	**2,482**

Table III-2.—Estimated Budget Effects of H.R. 3838, as Reported by the Committee on Finance, Fiscal Years 1986–1991—Continued

[Millions of dollars]

Title and Provision	1986	1987	1988	1989	1990	1991	1986–91
Employment		−130	−112	−144	−166	−177	−729
Excise		−10	−10	30	30	30	70
Total		2,869	7,055	7,775	9,363	10,427	37,489
XIII—Research and Development							
Incremental Research Tax Credit							
Individual	−32	−91	−104	−118	−92	−23	−460
Corporate	−616	−1,234	−1,522	−1,721	−1,223	−637	−6,953
Application of research expenses to foreign source income (Sec. 861)							
Corporate		−452	−237				−689
Personal holding companies							
Corporate		−47	−13	−14	−15	−17	−106
Subtotal, Research and Development							
Individual	−32	−91	−104	−118	−92	−23	−460
Corporate	−616	−1,733	−1,772	−1,735	−1,238	−654	−7,748
Total	−648	−1,824	−1,876	1,853	−1,330	−677	−8,208
XIV—Tax Shelters; Interest Expense; and Real Estate							
Limitation on passive losses							
Individual		1,410	5,139	6,818	8,597	9,430	31,394
Corporate		−587	−2,194	−2,996	−3,570	−3,402	−12,749
Limitation on deduction for nonbusiness interest							
Individual		723	5,059	6,616	7,780	8,014	28,192
At-risk rules							
individual		31	125	214	302	470	1,142
Corporate		−44	−129	−196	−288	−450	−1,107
Rehabilitation tax credits							
Individual		16	115	415	1,117	1,460	3,123

Corporate	28	52	197	312	337	926
low-income housing credit						
Individual	−60	−201	−312	−426	−536	−1,535
real estate investment trusts						
Individual	−12	−13	−13	−14	−15	−67
mortgage-backed securities						
Corporate	−2	−5	−5	−6	−6	−24
Subtotal, Real Estate						
Individual	**2,108**	**10,224**	**13,738**	**17,356**	**18,823**	**62,249**
Corporate	**−605**	**−2,276**	**−3,000**	**−3,552**	**−3,521**	**−12,954**
Total	**1,503**	**7,948**	**10,738**	**13,804**	**15,302**	**49,295**
XV—Tax-Exempt Bonds						
Individual	**−23**	**−127**	**−317**	**−475**	**−557**	**−1,499**
Corporate	**−2**	**−13**	**−29**	**−47**	**−65**	**−156**
Total	**−25**	**−143**	**−353**	**−538**	**−637**	**−1,691**
XVI—Unearned Income of Minor Children; Trusts and Estates; Estate and Gift Taxes						
Income of a minor child						
Individual	64	198	217	239	263	981
Revise taxation of estates and trusts						
Individual	67	209	226	244	265	1,011
Tax deferral for trusts						
Individual	1,169	123	128	130	132	1,682
Payment of income tax on estates and trusts						
Individual	427	311	31	32	34	835
Estate tax current use valuation						
Estate and gift	(3)	(3)	(3)	(3)	(3)	(4)

Table III-2.—Estimated Budget Effects of H.R. 3838, as Reported by the Committee on Finance, Fiscal Years 1986–1991—Continued

[Millions of dollars]

Title and Provision	1986	1987	1988	1989	1990	1991	1986–91
Disclaimers for gift and estate taxes							
Estate Gift [9]		−105	−26	([3])	([3])	([3])	−131
Subtotal, Trusts and Estates							
Individual		**1,727**	**841**	**602**	**645**	**694**	**4,509**
Estate and gift		**−105**	**−26**	([4])	([4])	([4])	**−131**
Total		**1,622**	**815**	**602**	**645**	**694**	**4,378**
XVII—Miscellaneous Tax Provisions							
Extend targeted jobs tax credit							
Individual	−9	−46	−62	−18	([3])	([3])	−135
Corporate	−22	−134	−265	−202	−112	−65	−800
Extension of expensing for removal of architectural barriers							
Corporate	−9	−17	−18	−19	−20	−21	−104
Rules for spouses of MIA's							
Individual		([3])	([3])	([3])	([3])	([3])	([4])
Exchanges and rentals of certain membership lists							
Corporate	−4	−7	−8	−9	−11	−12	−51
Tax exemption for certain title holding companies							
Individual		−2	−6	−11	−19	−28	−66
Corporate		−5	−12	−22	−37	−54	−130
Foundation business holdings							
Corporate		([3])	([3])	([3])	([3])	([3])	([4])
Interest and tax deductions of cooperative housing corporations							
Individual		([3])	([3])	([3])	([3])	([3])	([4])
Subtotal, Miscellaneous Tax Provisions							
Individual	**−9**	**−48**	**−68**	**−29**	**−19**	**−28**	**−201**
Corporate	**−35**	**−163**	**−303**	**−252**	**−180**	**−152**	**−1,085**

Total	−44	−211	−371	−281	−199	−180	−1,286
XVIII—Technical Corrections							
Individual		−180	−24	−25	−27	−31	−287
Corporate		−206	−99	34	34	28	−209
Total		−386	−123	9	7	−3	−496
Total, Tax Reform							
Individual	815	561	−35,636	−33,750	−17,712	−14,285	−100,007
Corporate	6,580	23,066	15,214	12,776	17,300	25,448	100,384
Excise		−6	62	109	116	124	405
Employment		−706	−356	−203	−115	−243	−1,623
Estate and gift		−101	−225	4	4	4	−111
Customs		[8]	[8]	[8]	[8]	[8]	[4]
GRAND TOTAL	7,395	22,814	−20,738	−21,064	−407	11,048	−952

[1] Rate change lines include the effects of changes relating to capital gains as well as interactions between rate changes and other provisions of the bill.

[2] Includes increased outlays. Changes to the earned income credit will increase outlays by $50 million in 1987, $1,376 million in 1988, $3,155 million in 1989, $3,505 million in 1990, and $3,846 million in 1991.

[3] Loss of less than $5 million.

[4] Amounts have not been assigned to footnotes for summation purposes. Therefore, totals do not include estimates represented by footnotes.

[5] Section dealing with attorney's fees will increase outlays by less than $5 million annually.

[6] Includes increased outlays. The IRS Trust Fund provision will increase outlays by $465 million in 1987, $765 million in 1988, $1,030 million in 1989, $1,055 million in 1990, and $1,100 million in 1991.

[7] Includes negligible outlay effects.

[8] Gain of less than $5 million.

[9] Amounts represent refunds of tax previously collected.

IV. EXPLANATION OF PROVISIONS
TITLE I—INDIVIDUAL INCOME TAX PROVISIONS

A. Basic Rate Structure:

Rate Reductions; Increase in Standard Deduction and Personal Exemptions; Repeal of Two-Earner Deduction (secs. 101-104, 131, and 151 of the bill and secs. 1, 63, 151, and 221 of the Code)

Present Law

Tax rates

Filing status classifications

Different tax rate schedules are provided in present law for each of four filing status classifications: (1) married individuals filing jointly[1] and certain surviving spouses; (2) heads of household; (3) single individuals; and (4) married individuals filing separately.

The term head of household means an unmarried individual (other than a surviving spouse) who pays more than half of the household expenses for himself or herself and a child or dependent relative who lives with the taxpayer, or for the taxpayer's dependent parents. A surviving spouse, who may use the rate schedule for married individuals filing jointly, is an individual whose spouse died during one of the two immediately preceding taxable years and who maintains a household that includes a dependent child.

Computation of tax liability

Tax liability is calculated by applying the tax rate from the appropriate schedule to the individual's taxable income. Taxable income equals adjusted gross income (gross income less certain exclusions and deductions) minus personal exemptions, and minus itemized deductions in excess of the zero bracket amount (ZBA). In addition, for 1986 individuals who do not itemize deductions are allowed a deduction for charitable contributions.

Tax rate schedules include the zero (tax rate) bracket amount as the first bracket; the ZBA is provided in lieu of a standard deduction. Itemizers may deduct the excess of their itemized deductions over the appropriate ZBA. Tax liability calculated from the rate schedules is reduced by applicable tax credits.

Under present law, tax rates in each schedule start at 11 percent in the first taxable income bracket above the ZBA (which has a zero tax rate) and rise to a maximum tax rate of 50 percent in the top bracket. Three of the schedules have 14 tax rates; the schedule for single individuals has 15 rates. Each tax rate applies only to

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[1] For tax purposes, an individual's marital status for a year generally is determined on the last day of the year. If one spouse dies during the year, the surviving spouse generally is eligible to file a joint return for that year.

income in its bracket, and tax rates increase as taxable income increases.

For married individuals filing joint returns and for surviving spouses in 1986, the 11-percent bracket starts at $3,670 of taxable income, and the 50-percent bracket at $175,250. For married individuals filing separate returns, the starting points for brackets are half of those for joint returns; thus, the first and last brackets begin at $1,835 and $87,625, respectively.

For a head of household, the 11-percent rate begins at taxable income of $2,480, and the 50-percent rate at $116,870. The tax rates applicable to a head of household are lower than those applicable to other unmarried individuals on taxable income above $13,920. Thus, a head of household in effect receives a portion of the benefits of the lower rates accorded to a married couple filing a joint return.

For single individuals (other than heads of household or surviving spouses), the 11-percent bracket begins at taxable income of $2,480, and the 50-percent bracket at taxable income of $88,270.

The bracket dollar amounts described above for 1986 have been indexed to reflect an inflation rate of approximately four percent in the preceding fiscal year, i.e., for the 12-month period ending September 30, 1985. For 1987 and later years, present law provides that the dollar figures defining the tax brackets are to be adjusted annually according to annual percentage changes in the consumer price index for the 12-month period ending September 30 of the preceding year.

Zero bracket amount (standard deduction)

The first positive taxable income bracket (i.e., the 11-percent marginal tax rate bracket) begins just above the ZBA. The ZBA for 1986 is $3,670 for married individuals filing joint returns and for surviving spouses ($1,835 for married individuals filing separately) and $2,480 for single returns, including a head of household. Beginning in 1985, the ZBA amounts are indexed annually for inflation during the preceding year.

The ZBA has been incorporated into the tax tables and tax rate schedules as the first tax bracket with a zero tax rate since 1977. Because the ZBA is the counterpart of the former standard deduction, nonitemizers can compute their tax liability merely by subtracting their personal exemptions (and the nonitemizer charitable deduction) from adjusted gross income (AGI), and then looking up the tax due in the tax tables published by the Internal Revenue Service. The ZBA also serves as a floor under the amount of itemized deductions. Itemizers reduce their AGI by their personal exemptions and by the excess of their itemized deductions over the appropriate ZBA, in order to avoid doubling the benefit of the ZBA, and then use the tax tables or tax rate schedule to find or compute their tax liability.

Personal exemption

The personal exemption for an individual, the individual's spouse, and each dependent is $1,080 for 1986. Under present law, one additional personal exemption is allowed for an individual who is age 65 or older, and for an individual who is blind.

Beginning with 1985, the amount of the personal exemption is adjusted annually to reflect inflation during the 12-month period that ended on the preceding September 30. Prior to 1986, the personal exemption amount had been $1,040 in 1985, $1,000 during 1979-84, $750 during 1972-78, $675 for 1971, $625 for 1970, and $600 for 1948-69.

Two-earner deduction

Married individuals filing a joint return are allowed a deduction from adjusted gross income equal to 10 percent of the earned income of the lower-earning spouse, up to $30,000, for a maximum deduction of $3,000. This provision has served to reduce the increase in tax liability that occurs when two individuals with relatively equal incomes marry and file a joint return.

Dependents with income

In general, an individual with gross income in excess of the personal exemption amount may not be claimed as a dependent on another taxpayer's return, even though that taxpayer satisfies the general support requirement by furnishing over half the dependent's support for the year. However, parents may claim a full dependency exemption for their dependent child who has income above the personal exemption amount, if the dependent child is under age 19 or a full-time student. In addition, an individual, including a child, for whom a dependency exemption may be claimed on another taxpayer's return also may claim a personal exemption on his or her own tax return, but may claim the ZBA only to the extent of earned income.

Reasons for Change

General objectives

The committee bill broadens the base of the individual and corporate income taxes, principally for the purpose of reducing marginal tax rates. This approach allows a considerable reduction in tax rates and in the overall income tax burden on individuals.

The provisions in the bill reducing tax rates for individuals and increasing the standard deduction, the personal exemption, and the earned income credit, were fashioned to achieve three important objectives: (1) to eliminate income tax burdens for families with incomes below the poverty line; (2) to provide an equitable distribution of tax reductions among individuals; and (3) to design the standard deduction and rate schedules to reduce the marriage penalty sufficiently so that there is no need for an additional deduction for two-earner couples. In addition, the increase in the standard deduction, coupled with changes to the itemized deductions, will reduce the number of individuals who must itemize their deductions, and thus will contribute to a simpler tax system.

Relief for low-income families

An overriding goal of the committee is to relieve families with the lowest incomes from Federal income tax liability. Consequently, the bill increases the amounts of both the personal exemption and the standard deduction, as well as the earned income credit, so

that the income level at which individuals begin to have tax liability (the tax threshold) will be raised sufficiently to free millions of poverty-level individuals from Federal income tax liability. This restores to the tax system an essential element of fairness that had eroded since the last increase in the personal exemption in 1978.

In addition, the bill reduces the burden of the Federal tax system on families with modest means, who also are subject to payroll taxes and various State and local government taxes. About six million taxpayers are dropped from the tax rolls as a result of these changes.

The ZBA and personal exemption were unchanged between the present levels set in the Revenue Act of 1978, and the beginning of inflation adjustments in 1985. Notwithstanding these adjustments, inflation has reduced the real value of the standard deduction and personal exemption in setting a threshold level below which income is not taxed. Although the rate reductions in 1981 reduced tax liabilities partly in recognition of the burdens of inflation and social security taxes, those reductions did not provide relief for marginally taxable individuals who would not have been subject to tax liability but for past inflation.

The increase in the personal exemption to $2,000 under the bill—the first statutory increase in the exemption since 1978—contributes to both removing the working poor from the tax rolls and extending relief to other low-income individuals. The personal exemption increase also recognizes the significant costs of raising children. Of course, the benefit of increases in the standard deduction and personal exemption is not limited to low-income individuals, because these increases reduce tax burdens for all families by raising the tax threshold for all taxpayers.

In the bill, all tax thresholds (the beginning point of income tax liability) are higher than the estimated poverty level for 1988 except for single individuals. In Table 1 below, the columns showing calculations without taking into account the earned income credit reflect the fact that the tax threshold for heads of households (unmarried individuals who support children or certain other dependent relatives) is raised proportionately more than the tax thresholds for married individuals filing jointly or single individuals. Married individuals receive a larger proportionate increase in the threshold than single individuals, in order to offset the effect of the repeal of the two-earner credit. With the addition of the earned income credit to the computation, the tax threshold rises even further for those eligible for the credit.

Table 1.—Income Tax Thresholds in Present Law and Committee Bill, 1988

[In 1986 dollars]

Filing status	Family size	Including earned income credit		Without earned income credit		Estimated poverty level
		Present law	Committee bill	Present law	Committee bill	
Single	1	3,830	5,000	3,830	5,000	6,156
Joint	2	6,270	9,000	6,270	9,000	7,878
Head of household	2	8,125	12,620	4,990	8,400	7,878
Joint	4	9,859	15,380	8,590	13,000	12,368
Head of Household	4	9,252	15,020	7,310	12,400	12,368

NOTE.—These calculations are based on the following assumptions: (1) inflation is equal to the figures forecast by the Congressional Budget Office; (2) families with dependents are eligible for the earned income credit; (3) all income consists of money wages and salaries; and (4) taxpayers are under age 65.

Although the committee is concerned about the tax burden on low-income single individuals, there are two principal reasons why the tax threshold under the bill for single persons (other than heads of households) is not above the poverty line. First, any further increases in the standard deduction for these taxpayers beyond those provided by the bill would cause significant marriage penalties for two single individuals who marry. Second, because the income tax does not combine the income of family members (other than spouses) in computing tax liability and does not recognize economies of sharing household costs with other individuals, income of single individuals is not a good measure of whether or not living conditions of these persons are impoverished.

More than two-thirds of all single individuals with income less than $10,000 are under age 25 and thus are likely to be receiving significant support from other family members that is not reflected on the tax return. In addition, the majority of single individuals between ages 25 and 64 live with other individuals, and thus share household costs. Thus, within the existing framework of defining the unit of tax liability, the committee believes that the poverty line is not an accurate guide to the true circumstances of the majority of those who file tax returns as unmarried individuals.

Equitable distribution of tax burden

The committee also believes that it is necessary to provide tax reductions that are distributed equitably among the vast majority of individuals who bear the tax burden. The next three tables show the changes made by the committee in the distribution of the tax burden. These tables reflect the effect of major provisions affecting individuals, including the rate reductions, increases in the standard

deduction and personal exemption, and changes in itemized deductions.

Table 2 below shows the changes in tax liabilities between present law and the committee bill for all income classes. The committee bill reduces total tax liability of individuals by 6.4 percent. The largest proportionate reductions in tax liability occur in the below $10,000 income class and the $10,000 to $20,000 income class, reflecting the committee's decision to increase the tax threshold above the poverty line. Decreases greater than the average 6.4 percent overall decrease in tax liability also affect the $20,000 to $30,000 and $40,000 to $50,000 income classes. The five other income classes receive smaller than average reductions, with the smallest decrease in percentage terms going to income classes over $50,000.

Table 2.—Percentage Changes in Income Tax Liability in Committee Bill, by Income Class, 1988

[In thousands of 1986 dollars]

Income class	Percentage change in income tax liability
Less than $10	−63.0
$10 to $20	−20.1
$20 to $30	−8.1
$30 to $40	−5.0
$40 to $50	−6.6
$50 to $75	−3.9
$75 to $100	−3.3
$100 to $200	−3.8
$200 and above	−4.7
Total	−6.4

NOTE.—These figures do not take account of certain provisions affecting individuals. Thus, the total tax reductions are somewhat different from what is indicated in this table.

Table 3 below shows that individuals with less than $75,000 of income will receive 73 percent of the reduction for individuals; these individuals make up more than 95 percent of income tax filers. The committee bill distributes 27 percent of the total tax reduction among taxpayers with incomes above $75,000.

Table 3.—Distribution of Individual Income Tax Changes in Committee Bill, by Income Class, 1988

[In thousands of 1986 dollars]

Income class	Percentage distribution of tax reduction
Less than $20	25.9
$20 to $75	47.6
$75 to $200	10.4
$200 and above	16.1
Total	100.0

NOTE.—Distributional figures do not take account of certain provisions affecting individuals. Thus, the total tax reductions are somewhat different from what is indicated in this table.

These tables reflect tax cuts for 1988, the first full year in which the changes in the tax rates and standard deduction are fully effective. By virtue of restructuring the tax schedules and broadening the tax base for individuals, and reducing corporate tax preferences, the committee bill produces substantial reductions in individual income tax liabilities.

Table 4.—Average Income Tax Liability and Tax Rate in Present Law and Committee Bill, by Income Class, 1988

[In 1986 dollars]

Income Class	Average tax liability		Average tax rate (percent)	
	Present law	Committee bill	Present law	Committee bill
0 to $10,000	$56	$13	1.2	0.3
$10,000 to $20,000	798	617	5.4	4.2
$20,000 to $30,000	1,952	1,766	7.8	7.0
$30,000 to $40,000	2,931	2,802	8.5	8.1
$40,000 to $50,000	4,521	4,184	10.1	9.4
$50,000 to $75,000	7,594	7,289	12.7	12.2
$75,000 to $100,000	13,515	12,951	15.8	15.2
$100,000 to $200,000	25,215	24,405	18.8	18.2
Over $200,000	124,198	118,306	22.2	21.2
Average tax liability or tax rate	3,347	3,132	11.4	10.6

The tax liability of all taxpayers will decline an average of $215, from an average $3,347 under present law in 1988 to an average $3,132 under the committee bill, as shown in Table 4. The average

tax rate will fall from 11.4 percent to 10.6 percent. In six income classes from $20,000 to $100,000, the average tax rate will decline by 0.4 to 0.8 percentage points. In the two lowest and the highest income classes, average tax rates will decline by 0.9 to 1.2 percentage points.

Rate schedules, ZBA, and standard deduction

The changes in the income tax burden result from revising tax rate schedules, converting the zero bracket amount back into the standard deduction and increasing the standard deduction amounts, and increasing the personal exemption amount.

The committee believes that the tax rate schedules in present law are too lengthy and complicated. The relatively narrow intervals between taxable income brackets make it difficult for individuals to understand how changes in tax liability relate to changes in income. The narrow intervals also cause an individual's marginal tax rate to be increased in response to relatively small increases in compensation or profits resulting from economic success and improved efficiency. Under the rate structure provided in the bill, more than 80 percent of individual taxpayers will either be in the 15-percent bracket or have no Federal income tax liability.

In its deliberations, the committee sought to modify the present-law rate structure to make the individual income tax fairer and simpler and to reduce disincentives to economic efficiency and growth. Simplicity in the rate structure was achieved by using only two taxable income brackets. The four filing statuses were retained because they are the fewest classifications that can be implemented to provide for the distinctive individual and familial circumstances of a diverse population.

The two-bracket tax structure includes only positive tax rates because the committee decided to delete the present-law ZBA from the tax structure and instead to restore the standard deduction. The committee understands that many individuals find the ZBA to be confusing and do not view it as a device that simplifies calculation of income tax liability. Under the committee bill, individuals will determine taxable income by subtracting from adjusted gross income either the standard deduction or the total amount of itemized deductions. Unlike the ZBA, the standard deduction enables the taxpayer to know directly how much income is subject to tax and to understand more clearly that taxable income is the base for determining tax liability.

Further, the difference between the standard deduction for an unmarried head of household and that for a married couple is narrowed. The bill provides larger increases for heads of households in recognition that the costs of maintaining a household for an unmarried individual and a dependent more closely resemble the situation of a married couple than that of a single individual without children.

The increases in the standard deduction and modifications to specific deduction provisions simplify the tax system by substantially reducing the number of itemizers. As a result of these changes, about 13 million itemizers will shift to using the standard deduction, a reduction of approximately 30 percent in the number of itemizers relative to present law.

Marriage penalty

The adjustment of the standard deduction and the rate schedule in the committee bill also makes it possible to minimize the marriage penalty while repealing the two-earner deduction. As a result, single individuals who marry will retain more of the share of the standard deductions for two single individuals than under present law.

Table 5 presents a comparison of the marriage penalty under present law and the committee bill for couples with varying individual income levels. In spite of the repeal of the two-earner deduction, marriage penalties generally are either smaller than present law or only a nominal amount higher in the committee bill. The only exceptions to this result occur for certain relatively high income couples, e.g., where the individuals have respective incomes of $100,000 and $30,000.

Table 5.—Marriage Tax Penalty For Two-Earner Couple in Present Law and Committee Bill, 1988

[In 1986 dollars]

Income of husband	Income of wife				
	$10,000	$20,000	$30,000	$50,000	$100,000
$10,000					
Present law	$60	−$13	−$102	−$417	−$2,241
Committee bill	150	105	−237	−831	−1,383
$20,000					
Present law	−13	97	270	475	−828
Committee bill	105	0	150	−12	−64
$30,000					
Present law	−102	270	533	1,161	211
Committee bill	−237	150	732	673	1,018
$50,000					
Present law	−417	475	1,161	2,470	2,295
Committee bill	−831	−12	673	1,511	1,856
$100,000					
Present law	−2,241	−828	211	2,295	3,979
Committee bill	−1,383	−64	1,018	1,856	825

NOTE.—The marriage bonus or penalty is the difference between the tax liability of a married couple and the sum of the tax liabilities of the two spouses had each been taxed as a single person. Marriage bonuses are negative in the table; marriage penalties are positive. It is assumed that all income is earned, that taxpayers have no dependents, that deductible expenses are 20.6 under present law and 15.2 percent under the Committee bill, and that deductible expenses are allocated between spouses in proportion to income.

Elderly and blind taxpayers

The tax burden on elderly or blind taxpayers is eased by the committee bill apart from the effect of rate reductions. The income tax credit for the elderly or disabled is left unchanged from present law. The present-law personal exemptions and ZBA (standard deduction) are restructured by increasing the standard deduction and personal exemptions (as previously discussed). The higher standard deduction goes into effect one year earlier (in 1987) for elderly or blind individuals than it does for all other taxpayers (in 1988), and it is augmented by an additional $600 for each elderly or blind individual. The additional $600 and higher personal exemptions and standard deduction offset loss of the additional personal exemption.

Explanation of Provisions

1. Tax rate schedules

The bill provides a new two-bracket tax rate schedule for individuals in each of the four filing status categories, with rates of 15 percent and 27 percent.

Reflecting the replacement of the ZBA by the standard deduction, the 15-percent bracket begins at taxable income of zero. (Taxable income equals AGI minus personal exemptions and minus either the standard deduction or the total of itemized deductions.) The 27-percent rate begins at taxable income levels of $29,300 for married individuals filing jointly and surviving spouses, $23,500 for heads of household, $17,600 for single individuals, and $14,650 for married individuals filing separately.[2]

For returns filed for taxable years beginning in 1987, the bill directs the Secretary of the Treasury to prepare blended tax rate schedules, constructed by assuming that the present-law rate schedules are in effect for one half of 1987 and that the new rate schedules are in effect for the other half. The blended schedule essentially will adjust the tax liability for 1987 tax returns at any given level of taxable income so that it approximates as closely as possible the sum of one-half of the tax liability calculated under the present-law schedules plus one-half of the tax liability calculated under the new rate schedules (including the rate adjustment described below). In determining the 1987 blended rate schedule, the present-law bracket amounts effective for 1986 are to be adjusted for inflation.

Fiscal-year taxpayers will use the same 1987 blended rate schedules as calendar-year taxpayers for taxable years beginning in 1987. The rules relating to proration in section 15 will not apply. The committee intends that the Federal income tax withholding schedules published by the IRS will be changed effective January 1, 1987, to reflect the blended rate schedules that apply for 1987.

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[2] The rate schedule for married individuals filing separately also applies to an estate taxable under sec. 1(d) for its taxable years ending less than two years after the date of the decedent's death. For an explanation of the rate structure applicable to estates and trusts, see Title XVI below.

Consistently with reducing the top rate for individuals to 27 percent, the bill amends sec. 541 to reduce to 27 percent (38.5 percent for 1987) the personal holding company tax on undistributed personal holding company income.

The benefit of the 15-percent bracket is phased out for taxpayers above certain income levels through a rate adjustment requiring additional tax liability. This adjustment is initially computed as equal to five percent of the excess of the taxpayer's AGI over the specified dollar amount for the taxpayer's filing status (as listed in the following paragraph), or, if less, as equal to five percent of the excess of the taxpayer's taxable income over the breakpoint between the 15 and 27 percent brackets. (For purposes of the 1987 blended rate schedules, the adjustment is computed by substituting 2-1/2 percent for five percent in the calculation.) However, the maximum rate adjustment cannot exceed 12 percent of the maximum amount of taxable income within the 15-percent bracket applicable to the filing status of the taxpayer.

For married individuals filing jointly or surviving spouses, the rate adjustment equals five percent of AGI in excess of $75,000, with the maximum rate adjustment of $3,516 (12 percent of $29,300) reached at AGI of $145,320; or, if less, five percent of taxable income in excess of the $29,300 breakpoint, with the maximum rate adjustment of $3,516 reached at taxable income of $99,620.[3] For heads of household, the rate adjustment applies to AGI between $55,000 and $111,400, or taxable income between $23,500 and $79,900, subject to a maximum of $2,820. For single individuals, the rate adjustment applies to AGI between $45,000 and $87,240, or taxable income between $17,600 and $59,840, subject to a maximum of $2,112. (As noted above, the rate adjustment for purposes of the 1987 blended rate schedules is computed by substituting 2½ percent for five percent in the calculation.)

The dollar amounts listed in the preceding paragraph do not reflect adjustments that will be made in 1988 and later years to reflect inflation. For example, for married individuals filing jointly, the rate adjustment for 1988 will be computed in part by reference to AGI levels beginning at $75,000 as increased to reflect inflation.

2. Standard deduction

Under the bill, the standard deduction replaces the ZBA, and is deducted by a nonitemizer from AGI in determining taxable income.

Effective in 1988, the standard deduction amounts are $5,000 for married individuals filing jointly and for surviving spouses, $4,400 for heads of households, $3,000 for single individuals, and $2,500 for married individuals filing separately. Beginning in 1989, these amounts will be adjusted for inflation.

An additional standard deduction amount of $600 is allowed for an elderly or blind individual ($1,200 for an individual who is both elderly and blind). For these taxpayers only, the new standard deduction amounts (listed in the preceding paragraph) and the additional $600 standard deduction amount are effective on January 1, 1987. Beginning in 1989, the $600 additional standard deduction amount will be adjusted for inflation.

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[3] For married individuals filing separate returns, the rate adjustment applies to AGI between $37,500 and $72,660, or taxable income between $14,650 and $49,810, with a maximum rate adjustment of $1,758.

For all individual taxpayers other than elderly or blind individuals, the standard deduction amounts for 1987 are $3,800 for married individuals filing jointly and surviving spouses, $2,570 for heads of households and single individuals, and $1,900 for married individuals filing separately.

As in present law, the IRS will continue to prepare tax tables reflecting the tax liability of individuals who use the standard deduction. (The IRS also may prepare tax tables for taxpayers who itemize, but these tables may not incorporate the standard deduction into the tables in the way the ZBA is now incorporated in the tax tables.) In preparing the tables, the IRS may adjust the size of the intervals between taxable income amounts in the tables to reflect meaningful differences in tax liability.

3. Personal exemption

In general

The bill increases the personal exemption amount for each individual, individual's spouse, and each dependent to $1,900 in 1987 and to $2,000 in 1988. Beginning in 1989, the $2,000 personal exemption amount will be adjusted for inflation.

In the bill, the personal exemption amounts are reduced for individuals with AGI exceeding the dollar amounts (described above) at which the 15-percent rate is totally phased out. The amount for each exemption is reduced by five percent of the excess of the taxpayer's AGI over the lowest amount of AGI which results in the maximum rate adjustment for taxpayers in that filing status.

Thus, the reduction of the $1,900 exemption amount for 1987 begins at AGI of $145,320 for married individuals filing jointly and surviving spouses, $111,400 for heads of household, $87,240 for single individuals, and $72,660 for married individuals filing separately. (These dollar amounts are subject to adjustments for inflation in 1988 and later years.) The reduction applies to all exemptions claimed on the return, i.e., for an individual, the individual's spouse, and eligible dependents.

The additional exemption in present law for the elderly and for blind individuals is repealed starting in 1987. As stated above, the bill provides an additional standard deduction amount of $600 for an elderly individual and for a blind individual, starting in 1987. In addition, in the bill, the increased standard deduction amounts (e.g., $5,000 for married individuals filing jointly) apply for elderly or blind individuals starting in 1987.

Rules for certain dependents

In the bill, the personal exemption is not allowed to an individual who is eligible to be claimed as a dependent on another taxpayer's return (for example, where a child is eligible to be claimed as a dependent on his or her parents' return), to avoid the double benefit allowed under present law when a dependent claims a personal exemption on his or her own tax return. In the bill, such an individual may use the standard deduction only to offset earned income; this rule is similar to the present-law rule applicable to the ZBA.

The bill provides that if an individual who is not allowed the personal exemption under this provision has gross income of less than $100, the individual is not subject to tax on that amount and is not required to file a Federal income tax return. Thus, for example, if a child's gross income consists of $85 in interest on a savings account, there would be no tax due and no return would have to be filed. If the child's gross income consists of $300 of interest, the de minimis rule would not apply, and the tax would be computed from the first dollar of taxable income (i.e., without subtracting $100).

4. Inflation adjustments

The new rate structure will be adjusted for inflation (indexed) beginning in 1988, to reflect inflation between the 12-month period ending on August 31, 1986 and the following 12-month period. The inflation adjustment, if any, will apply to the breakpoint between the 15-percent and 27-percent brackets, and to the income levels above which the rate adjustment and personal exemption reductions apply. Inflation adjustments will begin in 1989 to the increased standard deduction amounts that are generally effective for 1988, the $2,000 personal exemption amount for 1988, and the additional standard deduction amount of $600 for blind or elderly individuals (which goes into effect in 1987).

In the bill, inflation adjustments (except to the earned income credit) will be rounded down to the next lowest multiple of $50. For example, an inflation rate adjustment of four percent would raise the starting point of the 27-percent bracket for 1988 returns of married individuals filing jointly from $29,300 to $30,472; this amount then would be rounded down to $30,450 for purposes of constructing the indexed rate schedule.

In subsequent years, the indexing adjustment will reflect the rate of inflation from the 12-month period ended August 31, 1986, with respect to the rate brackets, or August 31, 1987, with respect to the $2,000 personal exemption and the increased standard deduction amounts. As a result, while rounding down affects the inflation adjustments made in each year, there is no cumulative result on the bracket thresholds and related amounts, since each year's inflation adjustment will be computed to reflect the cumulative rate of inflation from the initial base period. If the CPI currently published by the Bureau of Labor Statistics is revised, then the revision that is most consistent with the CPI for 1986 is to be used.

5. Repeal of two-earner deduction

The bill repeals the deduction for two-earner married couples after 1986. Adjustments made in the relationships of the standard deductions and rate schedules for unmarried individuals and married couples filing joint returns compensate for the repeal of this provision.

Effective Dates

The new tax rate schedules and rate adjustments are fully effective for taxable years beginning on or after January 1, 1988. As described above, blended tax rate schedules are to be prepared by the

Treasury Department for 1987. Section 15 will not apply to these provisions.

For taxable years beginning on or after January 1, 1987, the standard deduction replaces the ZBA, at the dollar amounts specified in the bill. The increased standard deduction amounts are effective for taxable years beginning on or after January 1, 1988. For elderly or blind individuals, the increased standard deduction amounts and the additional standard deduction amounts are effective for taxable years beginning on or after January 1, 1987.

The increase in the personal exemption amount to $1,900 is effective for taxable years beginning during 1987. The increase to $2,000 is effective for taxable years beginning on or after January 1, 1988.

The provision relating to rounding down of inflation adjustments is effective for taxable years beginning on or after January 1, 1987.

The repeal of the deduction for two-earner married couples is effective for taxable years beginning on or after January 1, 1987.

Revenue Effect

Tax rates

The changes in the income tax rates are estimated to decrease fiscal year budget receipts by $2,511 million in 1987, $52,885 million in 1988, $47,743 million in 1989, $36,715 million in 1990, and $35,971 million in 1991.

Standard deduction

The increases in standard deduction amounts are estimated to decrease fiscal year budget receipts by $1,104 million in 1987, $5,869 million in 1988, $7,971 million in 1989, $8,731 million in 1990, and $9,565 million in 1991.

Personal exemption

The increase in the personal exemption amount, and the repeal of the additional exemption for the elderly and blind and the exemption for an individual who is eligible to be claimed as a dependent on another taxpayer's return, are estimated to decrease fiscal year budget receipts by $13,127 million in 1987, $26,170 million in 1988, $27,083 million in 1989, $29,146 million in 1990, and $31,332 million in 1991.

Two-earner deduction

The repeal of the deduction for two-earner married couples is estimated to increase fiscal year budget receipts by $1,428 million in 1987, $6,108 million in 1988, $5,848 million in 1989, $6,217 million in 1990, and $6,609 million in 1991.

B. Increase in Earned Income Credit (Sec. 111 of the bill and secs 32 and 3507 of the Code)

Present Law

Under present law, an eligible individual is allowed a refundable income tax credit generally equal to 11 percent of the first $5,000 of earned income, for a maximum credit of $550 (Code sec. 32). The maximum allowable credit is phased down if the individual's adjusted gross income (AGI) or, if greater, earned income, exceeds $6,500; no credit is available for individuals with AGI or earned income equal to or exceeding $11,000.

The credit is available to (1) married individuals filing joint returns who are entitled to a dependency exemption for a child; (2) surviving spouses (i.e., a widow or widower who maintains a household for a dependent child); and (3) unmarried heads of households who maintain a household for a child. In each case, the credit is available only if the child resides with the taxpayer.

In order to relieve eligible individuals of the burden of computing the amount of credit to be claimed on their returns, tables are used for determination of the credit amount. Eligible individuals may receive the benefit of the credit in their paychecks throughout the year by electing advance payments (sec. 3507).

Reasons for Change

The earned income credit is intended to provide tax relief to low-income working individuals with children and to improve incentives to work. Periodically since enactment of the credit in 1975, the Congress has increased the maximum amount and the phase-out levels of the credit to offset the effects of inflation and social security tax increases.

The committee believes that further increases in the maximum amount and phase-out level of the credit are necessary to offset past inflation and increases in the social security tax. In addition, the committee believes that an automatic adjustment to the credit to reflect future inflation should be provided, just as it is provided for the personal exemption, the standard deduction, and rate brackets, in order to eliminate the reduction in the real value of the credit caused by inflation. Unlike these other indexed amounts, however, the inflation adjustment for the earned income credit will not be rounded down to the nearest $50-divisible amount, thereby providing additional benefits for low-income individuals entitled to the credit.

Explanation of Provision

Under the bill, the rate of the earned income credit is increased from 11 percent to 14 percent. Thus, the credit generally equals 14

percent of the first $5,000 of earned income; the maximum allowable amount of the earned income credit is increased from $550 to $700 (without taking into account any inflation adjustment).

In addition, the income levels over which the credit is phased out, at a rate of 10 percent, are higher than under present law. For taxable years beginning on or after January 1, 1987, the income level at which phase-down begins is $6,500; thus, no credit will be available for individuals with AGI or earned income of $13,500 or more. For taxable years beginning on or after January 1, 1988, the phase-down begins at income of $10,000; thus, no credit will be available at AGI or earned income exceeding $17,000.

Effective for taxable years beginning on or after January 1, 1987, the $5,000 maximum amount of earned income against which the credit applies and the income levels at which the phase-out of the credit begins ($6,500 in 1987 and $10,000 in 1988 and later years) will be adjusted for inflation occurring after the 12-month period ended August 31, 1984. These adjustments will not be subject to the rounding down rule applicable to inflation adjustments for the rate brackets, etc.; i.e., the adjustments relating to the earned income credit will not be rounded down to the nearest $50-divisible amount. Instead, any inflation adjustment relating to the credit that is not a multiple of $10 will be rounded down to the nearest multiple of $10 (or, if the increase is a multiple of $5, will be increased to the next highest multiple of $10).

Effective Date

The provision is effective for taxable years beginning after December 31, 1986.

Revenue Effect

This provision is estimated to decrease fiscal year budget receipts by $3 million in 1987, $200 million in 1988, $787 million in 1989, $985 million in 1990, and $1,216 million in 1991, and to increase fiscal year budget outlays by $50 million in 1987, $1,376 million in 1988, $3,155 million in 1989, $3,505 million in 1990, and $3,846 million in 1991. (To the extent that the amount of earned income credit exceeds tax liability and thus is refundable, it is treated as an outlay under budget procedures.)

C. Repeal of Income Averaging (Sec. 141 of the bill and secs. 1301-1305 of the Code)

Present Law

Under the income averaging rules (Code secs. 1301-1305), eligible individuals may reduce their tax liabilities for a year in which their income is at least 40 percent greater than their average income for the immediately preceding three years (the "base years"). In such a case, income averaging reduces tax liability by applying a lower marginal rate than would be used under the regular tax system to a portion of the current year's income.

In order to use income averaging, an individual must meet one of several alternative standards generally intended to restrict the availability of income averaging to individuals who were self-supporting during the base years. Under a provision enacted in the Consolidated Omnibus Budget Reconciliation Act of 1985 (P.L. 99-272), an individual who was a full-time student during one or more of the base years generally is not eligible for income averaging, effective for taxable years beginning after 1985.

Reasons for Change

The committee believes that, in light of the significantly flatter rate structure under the bill, there is no longer a need for income averaging. Moreover, the repeal of income averaging simplifies the tax system, by eliminating both the need for many individuals to make a complex series of computations—these are particularly complicated in the case of an individual whose marital status has changed during one of the three base years—and controversies with the Internal Revenue Service regarding whether an individual was self-supporting during any of the base years.

Explanation of Provision

The bill repeals income averaging after 1986.

Effective Date

The provision is effective for taxable years beginning after December 31, 1986.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $436 million in 1987, $1,855 million in 1988, $2,017 million in 1989, $2,170 million in 1990, and $2,333 million in 1991.

D. Exclusions from Income

1. Treatment of unemployment compensation benefits (sec. 121 of the bill and sec. 85 of the Code)

Present Law

Present law provides a limited exclusion from income for unemployment compensation benefits paid pursuant to a Federal or State program (Code sec. 85).

If the sum of the individual's unemployment compensation benefits and adjusted gross income (AGI) does not exceed a defined base amount, then no unemployment compensation benefits are included in gross income. The base amount is $18,000, in the case of married individuals filing a joint return; $12,000, in the case of an unmarried individual; and zero, in the case of married individuals filing separate returns. If the sum of unemployment compensation benefits and AGI exceeds the base amount, the amount of unemployment compensation that is included in gross income generally is limited to the lesser of (1) one-half the excess of the individual's AGI plus benefits over the base amount, or (2) the amount of the unemployment compensation benefits received.

Reasons for Change

Present law generally treats all cash wages and similar compensation (such as vacation pay and sick pay) received by an individual as fully taxable, but unemployment compensation benefits are taxable only if the taxpayer's income exceeds specified levels. The committee believes that unemployment compensation benefits, which essentially are wage replacement payments, should be treated for tax purposes in the same manner as wages or other wage-type payments. Also, when wage replacement payments are given more favorable tax treatment than wages, some individuals may be discouraged from returning to work. Repeal of the present-law partial exclusion contributes to more equal tax treatment of individuals with the same economic income and to tax simplification.

Explanation of Provision

Under the bill, all unemployment compensation benefits are includible in gross income after 1986.

Effective Date

The provision is effective for amounts received after December 31, 1986.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $235 million in 1987, $775 million in 1988, $749 million in 1989, $723 million in 1990, and $701 million in 1991.

2. Tax treatment of prizes and awards (sec. 122 of the bill and secs. 74, 102, and 274 of the Code)

Present Law

Under section 74, prizes and awards received by an individual (other than scholarships or fellowship grants) generally are includible in gross income. Treasury regulations provide that taxable prizes and awards include amounts received from giveaway shows, door prizes, awards in contests of all types, and awards from an employer to an employee in recognition of some achievement in connection with employment.

Section 74(b) provides a special exclusion from income for certain prizes and awards that are received for achievements in fields such as charity, the sciences, and the arts. This exclusion does not apply unless the recipient (1) has not specifically applied for the prize or award (for example, by entering a contest), and (2) is not required to render substantial services as a condition of receiving it. Treasury regulations state that the section 74(b) exclusion does not apply to prizes or awards from an employer to an employee in recognition of some achievement in connection with employment.[1]

While section 74 determines the includibility in income of prizes and awards, the treatment of other items provided by an employer to an employee may be affected by section 61, defining gross income, and section 102, under which gifts may be excluded from gross income. Section 61 provides in part that "gross income means all income from whatever source derived," including compensation for services whether in the form of cash, fringe benefits, or similar items. However, an item transferred from an employer to an employee, other than a prize or award that is includible under section 74, may be excludable from gross income if it qualifies as a gift under section 102.

The U.S. Supreme Court, in a case involving payments made "in a context with business overtones," has defined excludable gifts as payments made out of "detached and disinterested generosity" and not in return for past or future services or from motives of anticipated benefit (*Comm'r* v. *Duberstein,* 363 U.S. 278 (1960)). Under this standard, the Court said, transfers made in connection with employment constitute gifts only in the "extraordinary" instance.[2]

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[1] Treas. Reg. sec. 1.74-1(b). But see *Jones* v. *Comm'r,* 743 F.2d 1429 (9th Cir. 1984), holding that an award from an employer to an employee can qualify for the present-law section 74(b) exclusion under extraordinary circumstances. The court held that the exclusion applied in the case of a prominent scientist who was rewarded by the National Aeronautics and Space Administration (NASA) for lifetime scientific achievement, only part of which was accomplished while the scientist was employed by NASA. No inference is intended as to whether the decision of this case is correct under present law.

[2] Under *Duberstein,* the determination of whether property transferred from an employer to an employee (or otherwise transferred in a business context) constitutes a gift to the recipient is to be made on a case-by-case basis, by an "objective inquiry" into the facts and circumstances. If the transferor's motive was "the incentive of anticipated benefit," or if the payment was in return for services rendered (whether or not the payor received an economic benefit from the payment), then the payment must be included in income by the recipient.

Under certain circumstances, if an award to an employee constitutes an excludable gift, the employer's deduction may be limited pursuant to section 274(b). That section expressly defines the term "gift" to mean any amount excludable from gross income under section 102 that is not excludable under another statutory provision.

Section 274(b) generally disallows business deductions for gifts to the extent that the total cost of all gifts of cash, tangible personal property, and other items to the same individual from the taxpayer during the taxable year exceeds $25. Under an exception to the $25 limitation, the ceiling on the deduction is $400 in the case of an excludable gift of an item of tangible personal property awarded to an employee for length of service, safety achievement, or productivity. In addition, the ceiling on the employer's business gift deduction is $1,600 for an excludable employee award for such purposes when provided under a qualified award plan, if the average cost of all plan awards in the year does not exceed $400.

A further rule that may be relevant with respect to a prize or award arises under section 132(e), which provides that de minimis fringe benefits are excludable from income. A de minimis fringe generally is defined as "any property or service the value of which is (taking into account the frequency with which similar fringes are provided by the employer to the employer's employees) so small as to make accounting for it unreasonable or administratively impracticable."

Reasons for Change

Present-law exclusion

Prizes and awards generally increase an individual's net wealth in the same manner as any other receipt of an equivalent amount that adds to the individual's economic well-being. For example, the receipt of an award of $10,000 for scientific or artistic achievement which present law treats as tax-exempt increases the recipient's net wealth and ability to pay taxes to the same extent as the receipt of $10,000 in wages, dividends, or as a taxable award. Accordingly, the committee believes that prizes and awards generally should be includible in income even if received due to achievement in fields such as the arts and sciences.

In addition, the committee is concerned about problems of complexity that have arisen as a result of the present-law exclusion under section 74(b). The questions of what constitutes a qualifying form of achievement, whether an individual took action to enter a contest or proceeding, and whether or not the conditions of receiving a prize or award involve rendering "substantial" services, have all caused some difficulty in this regard. Finally, in some circumstances the present-law exclusion may serve as a possible vehicle for the payment of disguised compensation.

At the same time, the committee recognizes that in some instances the recipient of the type of prize or award described in section 74(b) may wish to assign it to charity, rather than claiming it for personal use. Accordingly, the bill provides that a prize or award meeting the present-law exclusion requirements under section 74(b) is excludable from gross income if, and only if, the prize

or award is transferred by the payor, pursuant to a designation made by the winner of the prize or award, to a governmental unit or to a tax-exempt charitable, educational, religious, etc. organization contributions to which are deductible under section 170(c)(1) or section 170(c)(2), respectively.

Employee awards

An additional reason for change relates to the tax treatment of employee awards of tangible personal property given by reason of length of service, safety achievement, or productivity. Except for items that may be able to qualify as de minimis fringes as defined by section 132(e), such employee awards are not excludable from the employee's gross income, and the deduction of their cost by the employer is not limited under section 274(b), if they cannot qualify as gifts because of either the "detached generosity" standard applicable under section 102 or the rule of section 74(a) that prizes and awards generally are includible in income.

The committee understands that uncertainty has arisen among some taxpayers concerning the proper tax treatment of an employee award. This uncertainty could lead some employers to seek to replace amounts of taxable compensation (such as sales bonuses) with "award" programs of tangible personal property. The business and the employee might contend that such awards are free from income or social security tax, but that the employer could still deduct the costs of the awards up to the section 274(b) limitations. In the case of highly compensated employees, who often might not be significantly inconvenienced by the fact that such awards would be made in the form of property rather than cash, an exclusion for transfers of property with respect to regular job performance (such as for productivity) could serve as a means of providing tax-free compensation.

Accordingly, the committee believes that it is desirable to provide express rules in this area. The committee believes that, in general, an award to an employee from his or her employer does not constitute a "gift" comparable to such excludable items as intrafamily holiday gifts, and should be included in the employee's gross income for income tax purposes and in wages for withholding and employment tax purposes. However, the committee believes that no serious potential for avoiding taxation on compensation arises from transfers by employers to employees of items of minimal value. Therefore, the committee wishes to clarify that the section 132(e) exclusion under present law for de minimis fringe benefits can apply to employee awards of low value, including traditional awards (such as a gold watch) upon retirement after lengthy service for an employer. In that case, the award is not made in recognition of any particular achievement, relates to many years of employment, and does not reflect any expectation of or incentive for the recipient's rendering of future services.

Also, the committee believes that, in certain narrowly defined circumstances, it is appropriate to recognize traditional business practices of making awards of tangible personal property for length of service or safety achievement. These traditional practices involve awards of such items as engraved plaques, desk accessories, or emblematic jewelry that identify or symbolize the awarding em-

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ployer or the achievement being recognized, and awards of items such as watches on retirement after lengthy service; such specialized items are not strictly equivalent, for example, to providing either a bonus in cash or an allowance of a dollar amount toward the purchase of ordinary merchandise. The committee believes that the double income tax benefit of excludability and deductibility is acceptable for such employee achievement awards under rules intended to prevent abuse and limit the scope of the double benefit.

Thus, the bill restricts the double benefit through dollar limitations, limits the frequency with which length of service awards can be made to the same employee, and limits safety achievement awards to the employer's nonprofessional work force and to no more than 10 percent of such eligible recipients in one year. In addition, the exclusion applies only if the item of tangible personal property is awarded under conditions and circumstances that do not create a significant likelihood of the payment of disguised compensation. Moreover, the committee believes that the fair market value of any prize or award to an employee that does not constitute either a length of service award or a safety achievement award qualifying under the bill or a de minimis fringe under section 132 should be includible in gross income for income tax purposes and (like employee achievement awards excludable for income tax purposes under the bill) in wages for employment tax purposes.

Explanation of Provisions

Scientific, etc. awards

Under the bill, the present-law exclusion under section 74(b) for certain prizes and awards for charitable, artistic, scientific, and like achievements is modified to apply only if the recipient designates that the prize or award is to be transferred by the payor to a governmental unit or a tax-exempt charitable, educational, religious, etc. organization contributions to which are deductible under section 170(c)(1) or 170(c)(2), respectively. If such designation is made and the prize or award is so transferred to a governmental unit or charitable organization by the payor, the prize or award is not included in the winner's gross income, and no charitable deduction is allowed either to the winner or to the payor on account of the transfer to the governmental unit or charitable organization.

For purposes of determining whether a prize or award that is so transferred qualifies as excludable under the bill, the present-law rules concerning the scope of section 74(b) are retained without change. In addition, in order to qualify for the section 74(b) exclusion as modified by the bill, the designation must be made by the taxpayer, and must be carried out by the organization making the prize or award, before the taxpayer uses the item that is awarded (e.g., in the case of an award of money, before the taxpayer spends, deposits, invests, or otherwise uses the money). Disqualifying uses by the taxpayer include such uses of the property with the permission of the taxpayer or by one associated with the taxpayer (e.g., a member of the taxpayer's family).

Employee awards

In general

The bill provides an exclusion from gross income, subject to certain dollar limitations, for an "employee achievement award" that satisfies the requirements set forth in the bill. The bill defines an employee achievement award as an item of tangible personal property transferred by an employer to an employee for length of service achievement or for safety achievement, but only if the item (1) is awarded as part of a meaningful presentation, and (2) is awarded under conditions and circumstances that do not create a significant likelihood of the payment of disguised compensation.[3] The exclusion applies only for awards of tangible personal property and is not available for awards of cash, gift certificates, or equivalent items.

An award for length of service cannot qualify for the exclusion if it is received during the employee's first five years of employment for the employer making the award, or if the employee has received a length of service achievement award (other than an award excludable under section 132(e)) from the employer during the year or any of the preceding four years. An award for safety achievement cannot qualify for the exclusion if made to an employee other than an eligible employee, or if, during the year, employee awards for safety achievement have previously been awarded by the employer to more than 10 percent of the employer's eligible employees. For this purpose, eligible employees are all employees of the taxpayer other than managers, administrators, clerical workers, and other professional employees, because persons occupying these positions do not engage in work involving significant safety concerns.

Deduction limitations

Under section 274 as amended by the bill, the employer's deduction limitation for all employee achievement awards (safety and length of service) provided to the same employee during the taxable year generally is $400. In the case of one or more qualified plan awards awarded to the same employee during the taxable year, however, the employer's deduction limitation for all such qualified plan awards (safety and length of service) is $1,600. In addition to these separate $400/$1,600 limitations, the $1,600 limitation applies in the aggregate if an employee receives one or more qualified plan awards during the year, and also one or more employee achievement awards that are not qualified plan awards; i.e., the $400 and $1,600 limitations cannot be added together to allow deductions exceeding $1,600 in the aggregate for employee achievement awards made to the same employee in a taxable year.[4]

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[3] The types of conditions and circumstances that are to be deemed to create a significant likelihood of payment of disguised compensation include, for example, the making of employee awards at the time of annual salary adjustments or as a substitute for a prior program of awarding cash bonuses, or the providing of employee awards in a way that discriminates in favor of highly paid employees.

[4] In the case of an employee award provided by a partnership, the deduction limitations of section 274(b) apply to the partnership as well as to each partner.

A qualified plan award is defined as an employee achievement award provided under a qualified award plan, i.e., an established, written plan or program of the taxpayer that does not discriminate in favor of highly compensated employees (within the meaning of sec. 414(q)) as to eligibility or benefits. However, an item cannot be treated as a qualified plan award if the average cost per recipient of all employee achievement awards made under all qualified award plans of the employer during the taxable year exceeds $400. In making this calculation of average cost, qualified plan awards of nominal value are not to be included in the calculation (i.e., are not to be added into the total of award costs under the plan). In the case of a qualified plan award the cost of which exceeds $1,600, the entire cost of the item is to be added into the total of award costs under the plan, notwithstanding that only $1,600 (or less) of such cost is deductible.

Excludable amount

In the case of an employee achievement award the cost of which is fully deductible by the employer under the dollar limitations of section 274 (as amended by the bill),[5] the fair market value of the award is fully excludable from gross income by the employee. For example, assume that an employer makes a length of service achievement award (other than a qualified plan award) to an employee in the form of a crystal bowl, that the employer makes no other length of service awards or safety achievement awards to that employee in the same year, and that the employee has not received a length of service award from the employer during the prior four years. Assume further that the cost of the bowl to the employer is $375, and that the fair market value of the bowl is $415. The full fair market value of $415 is excludable from the employee's gross income for income tax purposes under section 74 as amended by the bill.

If any part of the cost of an employee achievement award exceeds the amount allowable as a deduction by an employer because of the dollar limitations of section 274, however, then the exclusion does not apply to the entire fair market value of the award. In such a case, the employee must include in gross income the greater of (i) an amount equal to the portion of the cost to the employer of the award that is not allowable as a deduction to the employer (but not an amount in excess of the fair market value of the award) and (ii) the amount by which the fair market value of the award exceeds the maximum dollar amount allowable as a deduction to the employer. The remaining portion of the fair market value of the award is not included in the employee's gross income for income tax purposes.

Consider, for example, the case of a safety achievement award to an eligible employee that is not a qualified plan award, and that costs the employer $500; assume that no other employee achievement awards were made to the same employee during the taxable year, and that safety achievement awards had not previously been awarded during the year to more than 10 percent of eligible em-

[5] In the case of a tax-exempt employer, the deduction limitation amount is that amount that would be deductible if the employer were not exempt from taxation.

ployees of the employer. The employer's deduction is limited to $400. The amount includible in gross income by the employee is the greater of (1) $100 (the difference between the item's cost and the deduction limitation), and (2) the amount by which the item's fair market value exceeds the deduction limitation. If the fair market value equals, for example, $475, $100 is includible in the employee's income. If the fair market value equals $600, then $200 is includible in the employee's income.

Except to the extent that the new section 74(c) exclusion or section 132(e) applies, the fair market value of an employee award (whether or not satisfying the definition of an employee achievement award) is includible in the employee's gross income under section 61, and is not excludable under section 74 (as amended by the bill) or section 102 (gifts). The fair market value of an employee award (or any portion thereof) that is not excludable from income must be included by the employer on the employee's Form W-2, as is required under present law.

Any amount of an employee achievement award that is excludable from gross income under the bill is includible in wages or compensation for employment tax (e.g., FICA tax) purposes.

The committee bill does not modify section 132(e), under which de minimis fringe benefits are excluded from gross income. Thus, an employee award is not includible in income if its fair market value, after taking into account the frequency with which similar benefits are provided by the employer to the employer's employees, is so small as to make accounting for it unreasonable or administratively impracticable.

For purposes of sections 74 and 274 (as modified by the bill), an employee award that is excludable under section 132(e) is disregarded in applying the rules regarding how frequently an individual may receive a length of service award, or how many employees of an employer may receive a safety achievement award in the same taxable year. Under appropriate circumstances, however, the fact that an employer makes a practice of giving to its employees length of service or safety achievement awards that qualify under section 74 and 274 may affect the question of whether other items given to such employees (particularly if given by reason of length of service or safety achievement) qualify as de minimis fringe benefits under section 132(e).

The question of whether it is unreasonable or administratively impracticable (within the meaning of sec. 132(e)) to account for an item may be affected by the existence of a program whereby the taxpayer regularly accounts for other like items and complies with the statutory reporting requirements. Moreover, in some cases the fact that a particular employee receives items having the maximum fair market value consistent, respectively, with the employee achievement award and the de minimis fringe benefit exclusions may suggest that the employer's practice is not de minimis. This is particularly so when employee awards and other items, purportedly within the scope of section 132(e), are provided to the same individual in the same year.

The committee expects that the exclusion under section 132(e) for a de minimis fringe benefit will apply, under appropriate circumstances, to traditional retirement gifts presented to an employee on

his or her retirement after completing lengthy service, where the section 74(c) exclusion for length of service awards does not apply because the employee received such an award within the prior four years. In considering whether an item presented upon retirement qualifies as de minimis, the duration of the employee's tenure with the employer generally has relevance. For example, in the case of an employee who has worked for an employer for 25 years, a retirement gift of a gold watch may qualify for exclusion as a de minimis fringe benefit even though gold watches given throughout the period of employment would not so qualify for exclusion.

Effective Date

The provisions relating to the tax treatment of prizes and awards are effective for awards made in taxable years beginning after December 31, 1986.

Revenue Effect

The provisions relating to the tax treatment of prizes and awards are estimated to decrease fiscal year budget receipts by $19 million in 1987, $52 million in 1988, $55 million in 1989, $58 million in 1990, and $61 million in 1991.

E. Deductions for Personal Expenditures

1. Disallowance of itemized deduction for State and local sales taxes (sec. 135 of the bill and sec. 164 of the Code)

Present Law

Under section 164, itemizers may deduct four types of State and local taxes that are not incurred in a trade or business or in an investment activity—individual income taxes, real property taxes, personal property taxes, and general sales taxes.

Not all sales taxes imposed by State or local governments are deductible by itemizers. To be deductible, the sales tax must be imposed on sales (either of property or of services) at the retail level.[6] In addition, to be deductible the sales tax generally must apply at one rate to a broad range of items. However, sales taxes imposed at a lower rate on food, clothing, medical supplies, and motor vehicles are also deductible.[7] Other State or local sales taxes, such as any selective-rate taxes on sales of alcoholic beverages, tobacco, admissions, or solely on services, generally are not allowable as itemized deductions.

As an exception to the rule generally requiring taxpayers to substantiate deductions through recordkeeping, itemizers are permitted to claim sales tax deductions derived from IRS-published tables. These tables contain State-by-State estimates of liability for individuals at different income levels.[8]

Section 164(a) provides that, in addition to the deduction for certain taxes enumerated in that section, other State, local, and foreign taxes are deductible if paid or accrued in the taxable year in carrying on a business or investment activity. However, a specific provision of the Code (for example, secs. 189 and 263) may require capitalization of certain otherwise deductible taxes.

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[6] This test may be satisfied in the case of a compensatory use tax, i.e., a tax on the use, consumption, or storage of an item that would have been subject to a general sales tax if sold in the State or locality imposing the use tax (sec. 164(b)(2)(D)).

[7] In addition, the imposition of a sales tax on the purchase of motor vehicles at a rate higher than the general sales tax rate does not completely preclude deductibility for such tax. The deduction of such a tax is limited to the rate of the general sales tax for the State (sec. 164(b)(2)(E)).

[8] There is a separate table for each State having general sales taxes. The deductible amount is based on the taxpayer's AGI plus nontaxable items (such as nontaxed social security benefits) and on the number of persons in the taxpayer's household.

Local sales taxes also are imposed in various States. An additional amount for local taxes has been built into the table for some of these jurisdictions. For other states having local sales taxes, a further computation must be made after deriving the table amount (e.g., itemizers in one State were allowed to add sales taxes on electricity or gas during May through October 1984 to the table amount). Also, taxpayers generally may add to the table amount the actual State and local sales taxes paid on purchases of a boat, airplane, motor vehicle, or certain other large items.

Reasons for Change

The committee believes that, as part of the approach of its bill to reduce tax rates through base-broadening, it is appropriate to disallow the itemized deduction for State and local sales taxes. A number of additional considerations support the committee's decision.

First, itemized deductions already are not allowed under present law for various types of State and local sales taxes—such as selective sales taxes on telephone and other utility services, admissions, and sales of alcoholic beverages, tobacco, and gasoline. Also, present law does not allow consumers any deduction to reflect the inclusion in selling price of taxes levied at the wholesale or manufacturers' level. The committee believes that extending nondeductibility to all State and local sales taxes will improve the consistency of Federal tax policy by not providing an income tax benefit for any type of consumption.

Further, to the extent that sales taxes are voluntary costs of purchasing the consumer product or other items to which the taxes apply, the deduction is unfair because it favors taxpayers with particular consumption patterns, and is inconsistent with the general rule that costs of personal consumption by individuals are nondeductible.

Second, although the committee is aware of arguments that eliminating the sales tax deduction will provide unwarranted encouragement for States to shift away from these taxes and will be unfair to States that retain them, the committee did not find persuasive evidence for this view. On the contrary, it is significant how small a portion of general sales taxes paid by individuals actually are claimed as itemized deductions. Data from 1984 show that less than one-quarter of all such taxes levied are claimed as itemized deductions. By contrast, well over one-half of State and local income taxes paid by individuals are claimed as itemized deductions. The fact that the large majority of sales tax payments already are not claimed as itemized deductions under present law alleviates any effect of repealing the deduction on the regional distribution of Federal income tax burdens or on the willingness of State and local governments to use general sales taxes as revenue sources.

Third, for itemizers who do not rely on the IRS-published tables to estimate their deductible sales taxes, the deduction for sales taxes involves substantial recordkeeping and computational burdens, since the taxpayer must determine which sales taxes are deductible, must keep receipts or invoices showing the tax paid on each purchase, and must calculate the total of all deductible sales taxes paid. Also, allowing State and local sales taxes to be deducted creates legal controversies between taxpayers and the IRS regarding what is a general, as opposed to a specific, sales tax. Thus, repealing the deduction advances the committee's goal of simplifying the tax system for individuals.

For itemizers who do rely on the IRS tables, the amount of deductions that individuals can take without challenge from the IRS may vary significantly in particular instances from the amount of general sales taxes actually paid to State and local governments.

The tables do not provide accurate estimates for individuals who have either lower or higher levels of consumption than the average, and do not reflect the fact that an individual may purchase items in several States having different general sales tax rates. Accordingly, use of the tables neither accurately measures the amount of disposable income an individual retains after paying general sales taxes, nor accurately provides an appropriate Federal tax benefit to residents of States that use general sales taxes.

The committee also believes that the tax treatment of sales taxes incurred in a business or investment activity should be consistent with that of other costs of capital assets. Thus, for example, the amount of sales tax paid by a business on acquisition of depreciable property for use in the business will be treated under the bill as part of the cost of the acquired property for depreciation purposes.

Explanation of Provisions

The bill repeals the itemized deduction for State and local sales taxes under section 164.

The bill also amends section 164(a) with respect to deductibility or capitalization of State and local, or foreign, taxes incurred in a business or section 212 activity, *other than* (1) State and local, and foreign, real property taxes; (2) State and local personal property taxes; (3) State and local, and foreign, income, war profits, and excess profits taxes; and (4) the windfall profit tax (sec. 4986). (Present law regarding the deductibility or capitalization of these enumerated taxes is not changed by this provision of the bill, but may be modified by Title III of the bill.) For a State, local, or foreign tax other than those enumerated in the first sentence of this paragraph that is incurred by a taxpayer in connection with the acquisition or disposition of property, the tax shall be treated, respectively, as a part of the cost of the acquired property or as a reduction in the amount realized on the disposition.

Effective Date

The provisions are effective for taxable years beginning after December 31, 1986.

Revenue Effect

The provisions are estimated to increase fiscal year budget receipts by $714 million in 1987, $4,621 million in 1988, $3,867 million in 1989, $4,045 million in 1990, and $4,232 million in 1991.

2. Increased floor for itemized deduction for medical expenses (sec. 134 of the bill and sec. 213 of the Code)

Present Law

In general

Individuals who itemize deductions may deduct amounts paid during the taxable year, if not reimbursed by insurance or otherwise, for medical care of the taxpayer and of the taxpayer's spouse and dependents, to the extent that the total of such expenses exceeds five percent of adjusted gross income (sec. 213).

Medical care expenses eligible for the deduction are amounts paid by the taxpayer for (1) health insurance (including employee contributions to employer health plans); (2) diagnosis, treatment, or prevention of disease or malfunction of the body; (3) transportation primarily for and essential to medical care; and (4) lodging away from home primarily for and essential to medical care, up to $50 per night. The cost of a medicine or a drug is a medical care expense if it has been prescribed by a physician or is insulin.

Capital expenditures

Under Treasury regulations, the total cost of an unreimbursed capital expenditure may be deductible in the year of acquisition as a medical expense if its primary purpose is the taxpayer's (or dependent's) medical care (Reg. sec. 1.213-1(e)(1)(iii)). Qualified capital expenditures may include eyeglasses or contact lenses, motorized chairs, crutches, and artificial teeth. The cost of a movable air conditioner may qualify if purchased for the use of a sick person.

In addition, the cost of a permanent improvement to property that ordinarily would not have a medical purpose (such as central air conditioning or an elevator) may be deductible as a medical expense if directly related to prescribed medical care, but only for any portion of the cost that exceeds the increased value of the property attributable to the improvement. Related operating and maintenance costs also may be deducted provided that the medical reason for the capital expenditure continues to exist.

Under these rules, the Internal Revenue Service has treated as medical expenses the cost of hand controls and other special equipment installed in a car to permit its use by a physically handicapped individual, including a mechanical device to lift the individual into the car (Rev. Rul. 66-80, 1966-1 C.B. 57). Also, the IRS has ruled that the additional costs of designing an automobile to accommodate wheelchair passengers constitute medical expenses, including the costs of adding ramps for entry and exit, rear doors that open wide, floor locks to hold the wheelchairs in place, and a raised roof giving the required headroom (Rev. Rul. 70-606, 1970-2 C.B. 66). Similarly, specialized equipment used with a telephone by an individual with a hearing disability has been held deductible as a medical expense, since it was acquired primarily to mitigate the taxpayer's condition of deafness (Rev. Rul. 71-48, 1971-1 C.B. 99).

The IRS also has ruled that capital expenditures to accommodate a residence to a handicapped individual may be deductible as medical expenses (Rev. Rul. 70-395, 1970-2 C.B. 65). In that ruling, the taxpayer was handicapped with arthritis and a severe heart condition; as a result, he could not climb stairs or get into or out of a bathtub. On the advice of his doctor, he had bathroom plumbing fixtures, including a shower stall, installed on the first floor of a two-story house he rented. The lessor (an unrelated party) did not assume any of the costs of acquiring or installing the special plumbing fixtures and did not reduce the rent; the entire costs were paid by the taxpayer. The IRS concluded that the primary purpose of the acquisition and installment of the plumbing fixtures was for medical care, and hence that such expenses were deductible as medical expenses.

Reasons for Change

The committee believes that, as part of the approach of its bill to reduce tax rates through base-broadening, it is appropriate to increase the floor under the itemized deduction for medical expenses.

By utilizing a deduction floor of ten percent of the taxpayer's adjusted gross income, the bill continues the benefit of deductibility where an individual incurs extraordinary medical expenses—for example, as a result of uninsured surgery, severe chronic disease, or catastrophic illness. Thus, the bill retains deductibility where the expenses for a year are so great that they absorb a substantial portion of the taxpayer's income and hence substantially affect the taxpayer's ability to pay taxes. The committee also believes that the higher floor, by reducing the number of returns claiming the deduction, will alleviate complexity associated with the deduction, including substantiation and audit verification problems and numerous definitional issues.

The committee also concluded that it is desirable to clarify that certain capital expenditures incurred to accommodate a personal residence to the needs of handicapped individuals, such as construction of entrance ramps or widening of doorways to allow use of wheelchairs, constitute medical expenses eligible for the deduction. The committee believes that this clarification is consistent with Federal policies that seek to enable handicapped individuals to live independently and productively in their homes and communities, thereby avoiding unnecessary institutionalization.

Explanation of Provision

The bill increases the floor under the itemized medical expense deduction from five to 10 percent of the taxpayer's adjusted gross income.

The committee clarifies that capital expenditures eligible for the medical expense deduction include certain expenses incurred by a physically handicapped individual for removing structural barriers in his or her personal residence for the purpose of accommodating his or her handicapped condition. These costs are expenditures for: (1) constructing entrance or exit ramps to the residence; (2) widening doorways at entrances or exits to the residence; (3) widening or otherwise modifying hallways and interior doorways to accommodate wheelchairs; (4) railings, support bars, or other modifications to bathrooms to accommodate handicapped individuals; (5) lowering of or other modifications to kitchen cabinets and equipment to accommodate access by handicapped individuals; and (6) adjustment of electrical outlets and fixtures. (The enumeration of these specific types of expenditures is not intended to preclude the Treasury from identifying in regulations or rulings similar expenditures for accommodating personal residences for physically handicapped individuals that would be eligible for deductibility as medical expenses.)

The committee believes that the six categories of expenditures listed above would not add to the fair market value of a personal residence and hence intends that such expenditures are to count in full as eligible for the medical expense deduction.

Effective Date

The provision (increasing the deduction floor) is effective for taxable years beginning after December 31, 1986.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $350 million in 1987, $2,313 million in 1988, $2,225 million in 1989, $2,305 million in 1990, and $2,388 million in 1991.

3. Deductibility of mortgage interest and taxes allocable to tax-free allowances for ministers and military personnel (sec. 144 of the bill and sec. 265(1) of the Code)

Present Law

Code section 265(1) disallows deductions for expenses allocable to tax-exempt income, such as expenses incurred in earning income on tax-exempt investments. In addition, that provision has been applied in certain cases where the use of tax-exempt income is sufficiently related to the generation of a deduction to warrant disallowance of that deduction.

Section 107 provides that gross income does not include (1) the rental value of a home furnished to a minister as part of compensation, or (2) the rental allowance paid to a minister as part of compensation, to the extent the allowance is used to rent or provide a home. In January, 1983, the Internal Revenue Service ruled that section 265(1) precludes a minister from taking deductions for mortgage interest and real estate taxes on a residence to the extent that such expenditures are allocable to a tax-free housing allowance received by the minister (Rev. Rul. 83-3, 1983-1 C.B. 72). This ruling revoked a 1962 ruling which had taken a contrary position. In its 1983 ruling, the IRS stated that where a taxpayer incurs expenses for purposes for which tax-exempt income was received, permitting a full deduction for such expenses would lead to a double benefit not allowed under section 265(1) as interpreted by the courts.

The 1983 ruling generally was made applicable beginning July 1, 1983. However, for a minister who owned and occupied a home before January 3, 1983 (or had a contract to purchase a home before that date), the deduction disallowance rule was delayed by the IRS until January 1, 1985, with respect to such home (IRS Ann. 83-100). This transitional rule effective date was extended through 1985 by section 1052 of the Deficit Reduction Act of 1984 (P.L. 98-369) and through 1986 by administrative action of the IRS (Rev. Rul. 85-96, 1985-29 I.R.B. 7).

In July 1985, the IRS announced that it had not "concluded its consideration of the question of whether members of the uniformed services are entitled, under current law, to take deductions on their income tax returns for home mortgage interest and property taxes to the extent they receive tax-free housing allowances from the Federal Government" (IRS Ann. 85-104). The IRS also stated that "any determination on the issue that would adversely affect members of the uniformed services will not be applied to home mortgage interest and property taxes paid before 1987."

For purposes of this rule, the IRS stated, the uniformed services include all branches of the armed forces, the National Oceanic and Atmospheric Administration, and the Public Health Service. Eligible members of such services, the IRS announcement stated, are entitled to receive tax-free housing and subsistence allowances if they do not reside on a Federal base (see Treas. Reg. sec. 1.61-2(b)).

Reasons for Change

The committee believes that it is appropriate to continue the long-standing tax treatment with respect to deductions for mortgage interest and real property taxes claimed by ministers and military personnel who receive tax-free housing allowances. In determining the level of regular military compensation, the Federal Government has assumed that such treatment would be continued.

Explanation of Provision

Under the bill, Code section 265(1) shall not disallow deductions for mortgage interest or real property taxes paid or incurred with respect to a personal residence by (1) a minister, on account of a parsonage allowance that is excludable from gross income under section 107, or (2) a member of a military service, on account of a subsistence, quarters, or other housing allowance under Federal law. The term military service means the Army, Navy, Air Force, Marine Corps, Coast Guard, National Oceanic and Atmospheric Administration, and Public Health Service.

Effective Date

The provision applies for taxable years beginning before, on, or after December 31, 1986. The bill does not allow taxpayers to reopen any taxable years closed by the statute of limitations to claim refunds based on the provision.

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by less than $5 million annually.

F. Expenses for Business or Investment

1. Limitations on deductions for meals, travel, and entertainment (sec. 142 of the bill and secs. 162, 212, 274 and 6653 of the Code)

Present Law

Overview

In general, deductions are allowable for ordinary and necessary expenditures paid or incurred in carrying on a trade or business or for the production or collection of income (Code secs. 162, 212). Travel expenses incurred while away from home in the pursuit of a trade or business, including amounts expended for meals and lodging (other than amounts that are lavish or extravagant under the circumstances), generally qualify for the deduction (sec. 162(a)(2)).

The taxpayer bears the burden of proving both the eligibility of an expenditure as a deduction and also the amount of any such eligible expenditure.[9] In addition, certain limitations and special substantiation requirements apply to travel and entertainment deductions (sec. 274). Taxpayers are subject to penalties if any part of an underpayment of tax (e.g., because of improperly claimed deductions) is due to negligence or intentional disregard of rules or regulations (sec. 6653(a)) or due to fraud (sec. 6653(b)).

No deduction is allowed for personal, family, or living expenses (sec. 262). For example, the costs of commuting to and from work are nondeductible personal expenses.[10]

The Code also provides that no deduction is allowed for a payment that is illegal under any Federal law or State law (but only if such State law is generally enforced) that subjects the payor to a criminal penalty or the loss of a license or privilege to engage in a trade or business. For example, if paying more than the face value for a ticket ("scalping") is illegal under an enforced State law, this rule would disallow any otherwise available deduction of such payments as business entertainment expenses.

Entertainment activities

In general

Under present law, expenditures relating to activities generally considered to constitute entertainment, amusement, or recreation are deductible only if the taxpayer establishes that (1) the item was directly related to the active conduct of the taxpayer's business or (2), in the case of an item directly preceding or following a substantial and bona fide business discussion, the item was asscciated with

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[9] See, e.g., *Interstate Transit Lines* v. *Comm'r*, 319 U.S. 590, 593 (1943); *Comm'r* v. *Heininger*, 320 U.S. 467 (1943).

[10] *Fausner* v. *Comm'r*, 413 U.S. 838 (1973).

the active conduct of the taxpayer's business. The "directly related" and "associated with" tests are intended to require a more proximate relation between the entertainment expense and the taxpayer's business than would be required under the "ordinary and necessary" requirement applicable to all business expenses (including business entertainment expenses).

These special requirements apply (subject to ten statutory exceptions under present law discussed in greater detail below) to expenses of the taxpayer and the taxpayer's guests such as expenses incurred at nightclubs, cocktail lounges, theaters, country clubs, golf and athletic clubs, and sporting events, and on hunting, fishing, or vacation trips or yachts, as well as to expenses of providing food or beverages, lodging not used for business purposes, or the personal use of employer-provided automobiles. If either statutory test is met or an exception applies, entertainment expenses of the taxpayer as well as entertainment expenses of the taxpayer's business guests (such as present or potential customers or clients, legal or business advisors, suppliers, etc.) are deductible (assuming all generally applicable requirements are satisfied).

"Directly related" test

The regulations under section 274 provide several alternative tests for satisfying the "directly related" requirement, generally designed to require the taxpayer to show a clear business purpose for the expenditure and a reasonable expectation of business benefits to be derived from the expenditure. For example, under the "active business discussion" test, the taxpayer must have actively engaged in a business meeting during the entertainment period for the purpose of business benefit, and must have had more than a general expectation of deriving some income or other business benefit (other than merely goodwill) at some indefinite future time.

The regulations presume that the "active business discussion" test is not met if the entertainment occurred under circumstances where there was little or no possibility of engaging in business. For example, the test is presumed not to have been met if there were substantial distractions, e.g., because the entertainment took place at a nightclub or a cocktail party, or if the taxpayer met with a group including nonbusiness-related individuals at a vacation resort.

Even if the "active business discussion" test is not met, entertainment expenses are deemed "directly related" to business and hence satisfy the special section 274 limitation if incurred in a "clear business setting" directly in furtherance of the taxpayer's business. For example, the "clear business setting" test is met for expenses of entertainment taking place in a hospitality room at a convention, where business goodwill may be generated through the display of business products, or where civic leaders are entertained at the opening of a new hotel or theatrical production, provided that the clear purpose is to obtain business publicity. However, because of distracting circumstances, entertainment is presumed not to have occurred in a clear business setting in the case of a meeting or discussion taking place at a nightclub, theater, or sporting event, or during a cocktail party.

"Associated with" test

The second category of entertainment expenditures that are deductible under present law are expenses associated with the taxpayer's business that are incurred directly preceding or following a substantial and bona fide business discussion. This test generally permits the deduction of entertainment costs intended to encourage goodwill, where the taxpayer establishes a clear business purpose for the expenditure. Entertainment costs for the taxpayer's spouse, or the spouses of business customers, also may qualify for deduction under this test if meeting the general ordinary and necessary standard.

The "associated with" test does not require that business actually be transacted or discussed during the entertainment, that the discussion and entertainment take place on the same day, that the discussion last for any specified period, or that more time be devoted to business than to entertainment. Thus, if a taxpayer conducts negotiations with a group of business associates and that evening entertains them and their spouses at a restaurant, theater, concert, or sporting event, the entertainment expenses generally are deductible as "associated with" the active conduct of the taxpayer's business, even though the purpose of the entertainment is merely to promote goodwill. Entertainment taking place between business sessions or during evening hours at a convention is treated as directly preceding or following a business discussion.

Entertainment facilities

The section 274 rules were amended by the Revenue Act of 1978 to disallow any deduction (or the investment tax credit) for the cost of entertainment facilities, unless one of the specific statutory exceptions applies. This general disallowance rule applies to property such as "skyboxes" in sports arenas, tennis courts, bowling alleys, yachts, swimming pools, hunting lodges, fishing camps, and vacation resorts.

Dues or fees paid to a social, athletic, or sporting club are deductible provided that more than half the taxpayer's use of the club is in furtherance of the taxpayer's business and the item is directly related to the active conduct of the taxpayer's business. The expenses of box seats and season tickets to theaters and sporting events are not disallowed as expenses related to entertainment facilities. Instead, such costs are fully deductible if they meet the tests applied to entertainment activities.

Exceptions for certain entertainment

In general

There are ten statutory exceptions to the general section 274 rules that an entertainment, recreation, or amusement activity expenditure must satisfy either the "directly related" or "associated with" tests, and that entertainment facility costs are not deductible. If an exception applies, the entertainment expenditure is deductible if it is ordinary and necessary and if any applicable section 274(d) substantiation requirements are satisfied.

These exceptions are for (1) business meals (discussed below), (2) food and beverage furnished to employees on the taxpayer's busi-

ness premises, (3) entertainment expenses treated by the employer and employee as compensation to the employee, (4) expenses paid by the taxpayer under a reimbusement or other expense allowance arrangement in connection with the performance of services, (5) expenses for recreational, social, or similar facilities or activities for the benefit of employees generally, (6) entertainment expenses directly related to bona fide meetings of a taxpayer's employees, stockholders, or directors, (7) entertainment expenses directly related to and necessary to attendance at a business meeting or convention of a tax-exempt trade association, (8) expenditures for entertainment (or a related facility) made available by the taxpayer to the general public, (9) expenses for entertainment sold by the taxpayer to the public, and (10) expenses includible in the income of persons who are not employees.

The regulations under section 274 provide that entertainment expenditures are not deductible to the extent they are lavish or extravagant. The Internal Revenue Service has not interpreted this provision to disallow deductions merely because entertainment expenses exceed a fixed dollar amount, are incurred at expensive restaurants, hotels, nightclubs, or resorts, or because they involve first-class accommodations or services (see Rev. Rul. 63-144, 1963-2 C.B. 129).

Meals

Expenses for food and beverage are deductible, without regard to the "directly related" or "associated with" requirements generally applicable to entertainment expenses, if the meal or drinks take place in an atmosphere conducive to business discussion (sec. 274(e)(1)). In general, the deduction covers both the expenses of the taxpayer's business guest and of the taxpayer, notwithstanding that meal expenses of an individual (unless incurred away from home on a business trip) otherwise are nondeductible personal expenses.

There is no requirement that business actually be discussed either before, during, or after the meal. For example, if the taxpayer takes a potential customer to breakfast, lunch, or dinner at a restaurant or hotel, or to a bar for drinks, the costs of the food and beverages are deductible whether or not any business is discussed. The legislative history of the 1962 Act indicates that this "business meals" exception to section 274(a) thus exempts a significant portion of business "goodwill" entertaining from the restrictions generally applicable to entertainment expenses.

Under the exception, meals in a restaurant or hotel dining room are deductible in the absence of distractions such as floor shows. Business entertaining at the taxpayer's home also qualifies if the taxpayer shows that the expenditure was commercially, rather than socially, motivated. In such situations, expenditures for meals of a customer's spouse, and for the taxpayer's spouse who helps entertain a business customer, are deductible if they meet the general "ordinary and necessary" standard. However, entertainment at a night club, sporting event, or large cocktail party generally does not qualify for the business meal exception.

Travel expenses

Away from home travel

Traveling expenses incurred by the taxpayer while "away from home" in the conduct of a trade or business (e.g., where the taxpayer travels to another city for business reasons and stays there overnight) generally are deductible if the ordinary and necessary standard is met. The "away from home" deduction applies to personal living expenses such as food and lodging incurred during the trip. However, travel deductions for meals and lodging are subject to disallowance if they are "lavish and extravagant" (sec. 162(a)(2)), and must be substantiated pursuant to section 274(d).

Additional rules apply in the case of travel outside the United States (sec. 274(c)). In general, if an individual engages in both business and personal activities while outside the United States, the deduction is computed by multiplying the otherwise allowable amount by the ratio of business days to total number of days abroad. However, this allocation is not required for travel not exceeding one week; where vacation purposes were not a major consideration in the travel; or if less than 25 percent of the total travel days were spent on nonbusiness activities.

Foreign conventions; cruise ship conventions

No deductions for expenses allocable to a convention, seminar, or similar meeting held outside the "North American area" are allowed unless (a) the taxpayer establishes that the convention is related directly to the active conduct of the taxpayer's trade or business; and (b) the taxpayer establishes that it is as reasonable for the meeting to be held outside the North American area as within it, taking into account certain specified factors. The factors to be taken into account, in the manner prescribed by Treasury regulations, include the purpose of and activities at the convention; the purposes and activities of the convention sponsor; and the residences of the members of the sponsor. If the taxpayer satisfies these special foreign convention requirements, the general foreign travel allocation rules (sec. 274(c)) also may apply.

Section 274(h)(3) defines the North American area as the United States, its possessions, the Trust Territory of the Pacific Islands, Canada, and Mexico. Under the Carribbean Basin Economic Recovery Act of 1983 (P.L. 98-67), qualifying Caribbean countries may be included within the North American area if three requirements are met (sec. 274(h)(6)).

First, the Caribbean country must be a "beneficiary country" designated by the President as described in section 212(a)(1)(A) of the 1983 statute; 27 Caribbean countries are listed, including all major Caribbean countries except Cuba. In addition, Bermuda also can be a country designated by the President. Second, the Caribbean country must enter into an exchange of information agreement with the United States relating to tax matters. Third, the deduction is not available if the Secretary of the Treasury finds that the tax laws of the country discriminate against conventions held in this country.

Deductions for conventions held on cruise ships are limited to $2,000 per taxpayer per year, and are wholly disallowed unless the

cruise ship is registered in the United States and stops only at ports of call in this country (including United States possessions) (sec. 274(h)(2)).

Traveling costs as deductible education expenses

Traveling expenses may be deductible as business expenses if the travel (1) maintains or improves existing employment skills or is required by the taxpayer's employer or by applicable rules or regulations, and (2) is directly related to the taxpayer's duties in his or her employment or trade or business. Examples of travel expenses that may qualify for this deduction, depending on the particular circumstances, include the expenses of a trip to France by a teacher of French who is on sabbatical leave from school, and a management professor's tour of foreign businesses.

General substantiation requirements

As a general rule, deductions for travel, entertainment, and certain gift expenses are subject to stricter substantiation requirements than most other business deductions (sec. 274(d)). These stricter rules were enacted because Congress recognized that "in many instances deductions are obtained by disguising personal expenses as business expenses."[11]

Under the section 274 rules, the taxpayer must substantiate by adequate records, or sufficient evidence corroborating the taxpayer's statement, (1) the amount of the expense or item subject to section 274(d); (2) the time and place of the travel, entertainment, amusement, recreation, or use of the facility or property, or the date and description of the gift; (3) the business purpose of the expense or other item; and (4) the business relationship to the taxpayer of persons entertained, using the facility or property, or receiving the gift. These substantiation rules apply to: (1) traveling expenses (including meals and lodging while away from home); (2) expenditures with respect to entertainment, amusement, or recreation activities or facilities; and (3) business gifts. In addition, the Tax Reform Act of 1984 made additional property subject to the section 274(d) rules, including automobiles used for local travel; these additional categories of expense became subject to the section 274(d) substantiation requirements on January 1, 1986.

Reasons for Change

In general

Since the 1960's, the Congress has sought to address various aspects of deductions for meals, entertainment, and travel expenses that the Congress and the public have viewed as unfairly benefiting those taxpayers who are able to take advantage of the tax benefit of deductibility. In his 1961 Tax Message, President Kennedy reported that "too many firms and individuals have devised means of deducting too many personal living expenses as business expenses, thereby charging a large part of their cost to the Federal Government." He stated: "This is a matter of national concern, affecting not only our public revenues, our sense of fairness, and our

[11] H. Rpt. No. 87-1447, 87th Cong., 2d Sess. (1962), at 19.

respect for the tax system, but our moral and business practices as well."

The committee shares these concerns, and believes that these concerns are not addressed adequately by present law. In general, present law requires some heightened showing of a business purpose for travel and entertainment costs, as well as stricter substantiation requirements than those applying generally to all business deductions. However, the present-law approach fails to address a basic issue inherent in allowing deductions for many travel and entertainment expenditures--the fact that, even if reported accurately and having some connection with the taxpayer's business, such expenditures also convey substantial personal benefits to the recipients.

The committee believes that present law, by not focusing sufficiently on the personal-consumption element of deductible meal and entertainment expenses, unfairly permits taxpayers who can arrange business settings for personal consumption to receive, in effect, a Federal tax subsidy for such consumption that is not available to other taxpayers. The taxpayers who benefit from deductibility under present law tend to have relatively high incomes, and in some cases the consumption may bear only a loose relationship to business necessity. For example, when executives have dinner at an expensive restaurant following business discussions and then deduct the cost of the meal, the fact that there may be some bona fide business connection does not alter the imbalance between the treatment of those persons, who have effectively transferred a portion of the cost of their meal to the Federal Government, and other individuals, who cannot deduct the cost of their meals.

The significance of this imbalance is heightened by the fact that business travel and entertainment often may be more lavish than comparable activities in a nonbusiness setting. For example, meals at expensive restaurants and season tickets at sporting events are purchased to a significant degree by taxpayers who claim business deductions for these expenses. This disparity is highly visible, and contributes to public perceptions that the tax system is unfair. Polls indicate that the public identifies the deductibility of normal personal expenses such as meals to be one of the most significant elements of disrespect for and dissatisfaction with the present tax system.

In light of these considerations, the committee bill generally reduces by 20 percent the amount of otherwise allowable deductions for business meals and entertainment. This reduction rule reflects the fact that meals and entertainment inherently involve an element of personal living expenses, but still allows an 80 percent deduction where such expenses also have an identifiable business relationship. The bill also tightens the requirements for establishing a bona fide business reason for claiming meal and entertainment expenses as deductions. The bill includes exceptions to the general percentage reduction rule for certain traditional employer-paid recreational expenses for employees, de minimis fringe benefits, promotional activities made available to the general public, costs for certain sports events related to charitable fundraising, and meals provided as an integral part of certain business meeting programs during 1987-88.

Required business purpose for meals

In certain respects, more liberal deduction rules are provided under present law with respect to business meals than other entertainment expenses, both as to the underlying legal requirements for deductibility and as to substantiation requirements. The committee believes that more uniform deduction rules should apply. In addition, the committee believes that business meals should be deductible only if the meal has a clear business purpose currently related to the active conduct of the taxpayer's trade or business. The committee also believes that special penalties should apply when taxpayers fraudulently or negligently claim business meal deductions to which they are not entitled.

Excess ticket costs

In some cases, taxpayers may claim entertainment expense deductions for ticket purchases that exceed the face value of the tickets. For example, a taxpayer may pay an amount in excess of the face price to a "scalper" or ticket agent. The committee believes that deductions for ticket costs in excess of the face value amount generally should not be allowed. However, this limitation does not apply to ticket expenses for sports events meeting certain requirements under the bill relating to charitable fundraising.

Luxury water travel

The committee believes that present law may allow excessive deductions for business travel undertaken by luxury water travel (e.g., by cruise ship). Taxpayers who engage in luxury water travel ostensibly for business purposes may have chosen this means of travel for personal enjoyment over other reasonable alternatives that may better serve business purposes by being faster and less expensive. Also, the costs of cruise ship travel may include elements of entertainment and meals (not separately charged) that are not present in other transportation. Accordingly, the committee bill generally places per diem dollar limitations on deductions for luxury water transportation.

Travel as a form of education

The committee is concerned about deductions claimed for travel as a form of education. The committee believes that any business purpose served by traveling for general educational purposes, in the absence of a specific need such as engaging in research which can only be performed at a particular facility, is at most indirect and insubstantial. By contrast, travel as a form of education may provide substantial personal benefits by permitting some individuals in particular professions to deduct the cost of a vacation, while most individuals must pay for vacation trips out of after-tax dollars, no matter how educationally stimulating the travel may be. Accordingly, the committee bill disallows deductions for travel that can be claimed only on the ground that the travel itself is educational, but permits deductions for travel that is a necessary adjunct to engaging in an activity that gives rise to a business deduction relating to education.

Expenses for nonbusiness conventions

The committee is concerned about deductions claimed for travel and other costs of attending conventions or other meetings that relate to financial or tax planning of investors, rather than to a trade or business of the taxpayer. For example, individuals claim deductions for attending seminars about investments in securities or tax shelters. In many cases, these seminars are held in locations (including some that are overseas) that are attractive for vacation purposes, and are structured so as to permit extensive leisure activities on the part of attendees.

Since investment purposes do not relate to the taxpayer's means of earning a livelihood (i.e., a trade or business), the committee believes that these abuses, along with the personal consumption issue that arises with respect to any deduction for personal living expenses, justify denial of any deduction for the costs of attending a nonbusiness seminar or similar meeting that does not relate to a trade or business of the taxpayer. However, this disallowance rule does not apply to expenses incurred by a taxpayer in attending a convention, seminar, sales meeting, or similar meeting relating to the trade or business of the taxpayer.

Foreign convention rules

The committee believes that it is appropriate to provide that Bermuda will be treated as within the North American area for purposes of the foreign convention deductibility rules if the President certifies that such treatment is in the national security interest of the United States and that the information exchange programs of Bermuda do not materially impede the administration and enforcement of U.S. tax laws.

Explanation of Provisions

a. Percentage reduction for meal and entertainment expenses

In general

Under the bill, the amount of an otherwise allowable deduction for a meal or entertainment expense is reduced by 20 percent. For example, if a taxpayer spends $100 for a business meal which, but for this rule, would be fully deductible, the amount of the allowable deduction is $80.

For purposes of this rule, meals and entertainment activities generally are defined as under present law. Thus, 20 percent of an otherwise allowable deduction for food or beverages, including food or beverage costs incurred in the course of travel away from home, is disallowed. Similarly, the cost of a meal furnished by an employer to employees on the employer's premises is subject to the rule. An entertainment activity is defined, for purposes of this rule, in accordance with section 274(a)(1)(A), i.e., as an activity which is of a type generally considered to constitute entertainment, amusement, or recreation. (See discussion below of certain exceptions to the percentage reduction rule.)

In determining the amount of the otherwise allowable deduction that is subject to reduction under this rule, expenses for taxes and tips relating to a meal or entertainment activity are included. For

example, in the case of a business meal for which the taxpayer pays $50, plus $4 in tax and $10 in tips, the amount of the deduction cannot exceed $51.20 (80 percent of $64). Expenses such as cover charges for admission to a night club, the amount paid for a room which the taxpayer rents for a dinner or cocktail party, or the amount paid for parking at a sports arena in order to attend an entertainment event there, likewise are deductible only to the extent of 80 percent under the rule. However, an otherwise allowable deduction for the cost of transportation to and from a business meal (e.g., cab fare to a restaurant) is not reduced pursuant to the rule.

The percentage reduction rule is applied only after determining the amount of the otherwise allowable deduction under sections 162 and 274. Meal and entertainment expenses first are limited to the extent (if any) required pursuant to other applicable rules set forth in section 162 or section 274, and then are reduced by 20 percent.[12]

For example, if a travel meal costs $100, but, under section 162(a)(2), $40 of that amount is disallowed as "lavish and extravagant," then the remaining $60 is reduced by 20 percent, leaving a deduction of $48. Similarly, when a taxpayer buys a ticket to an entertainment event for more than the ticket's face value, the deduction cannot exceed 80 percent of the face value of the ticket. However, the effect of the percentage disallowance rule is determined prior to application of deduction limits other than those contained in sections 162 and 274.

Exceptions to percentage reduction rule

The bill provides certain exceptions to the applicability of the percentage reduction rule.

First, the cost of a meal or of an entertainment activity is fully deductible if the full value thereof is taxed as compensation to the recipients (whether or not they are employees) or is excludable under section 132, pursuant to either the subsidized eating facility exclusion or the exclusion for de minimis fringe benefits. For example, a transfer for business purposes of a packaged food or beverage item (e.g., a holiday turkey or ham, fruitcake, or bottle of wine) is not subject to the percentage reduction rule where the de minimis fringe benefit exclusion applies.

Second, in the case of a taxpayer who is reimbursed for the cost of a meal or of entertainment, the percentage reduction rule instead applies to the party making the reimbursement. This exception may apply, for example, in the case of a salesperson who pays for a lunch with a customer at which a sales contract is discussed and then is reimbursed by his or her employer; in that case, the employer could deduct only 80 percent of the reimbursement.

Third, the percentage reduction rule does not apply in the case of certain traditional recreational expenses for employees that are paid by employers. For example, this exception may apply in the

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[12] However, in the case of a separately stated meal or entertainment cost incurred in the course of luxury water travel, the percentage disallowance rule is applied prior to application of the limitation on luxury water travel expenses (discussed below).

case of an employer's deduction for reasonable costs of a year-end holiday party or a summer outing for employees and their spouses.

Fourth, the reduction rule does not apply in the case of items, such as samples and promotional activities, that are made available to the general public. For example, if the owner of a hardware store advertises that tickets to a baseball game will be provided to the first 50 people who visit the store on a particular date, or who purchase an item from the store during a sale, then the full amount of the face value of the tickets is deductible by the owner. Similarly, a wine merchant who permits potential customers to sample wine of the type that the merchant is offering for sale may deduct in full the cost of wine used as a sample, along with reasonable costs that are associated with the winetasting (e.g., food that is provided with the wine to demonstrate the suitability of the wine for particular types of meals.)

Fifth, expenses for attendance at a sports event, to the extent otherwise allowable as a business deduction, are not subject to the percentage reduction rule if the event meets certain requirements related to charitable fundraising. In order for such costs to be fully deductible as a business expense under this rule, the event must (1) be organized for the primary purpose of benefiting a tax-exempt charitable organization (described in sec. 501(c)(3)), (2) contribute 100 percent of the net proceeds to the charity, and (3) use volunteers for substantially all work performed in carrying out the event. This rule applies to the cost of a ticket package, i.e., the amount paid both for seating at the event, and for related services such as parking, use of entertainment areas, contestant positions, and meals furnished at and as part of the event.

For example, a golf tournament that donates all of the net proceeds from the event to charity is eligible to qualify under this exception. Such a tournament would not fail to qualify solely because it offered prize money to golfers who participated, or used paid concessionaires or security personnel. However, the committee intends that tickets to college or high school football or basketball games or other similar scholastic events will not qualify under the exception. Such games generally do not satisfy the requirement that substantially all work be performed by volunteers, if the institutions (or parties acting on their behalf) pay individuals to perform such services as coaching or recruiting.

Sixth, the cost of providing meals or entertainment is fully deductible to the extent that it is sold by the taxpayer in a bona fide transaction for an adequate and full consideration in money or money's worth. For example, a restaurant may deduct the full amount of its ordinary and necessary expenses in providing meals to paying customers.

Seventh, the full cost of a meal that is provided as an integral part of a qualified banquet meeting (if charges for the meal are not separately stated) will be deductible for calendar years 1987 and 1988. Beginning on or after January 1, 1989, the 80-percent reduction rule will apply to qualified banquet meeting meals in the same manner as to other business meals.

For purposes of this two-year exception, the term banquet meeting means a convention, seminar, annual meeting, or similar business program that includes the meal. The exception applies only if

more than 50 percent of the participants at the banquet meeting are away from home (i.e., can deduct travel expenses under the "overnight" rule); (2) at least 40 persons attend the banquet meeting; and (3) the meal event is part of the banquet meeting and includes a speaker.

b. Additional requirements relating to meals

The committee bill also makes certain changes in the legal and substantiation requirements applying to deductions for business meals.

First, the bill provides that a meal expense, like other entertainment expenses under present law, is not deductible unless the taxpayer establishes that the item was directly related to the active conduct of the taxpayer's trade or business, or, in the case of an item directly preceding or following a substantial and bona fide business discussion (including business meetings at a convention or otherwise), that the item was associated with the active conduct of the taxpayer's trade or business. Under this standard, a business meal expense generally is not deductible unless there is a substantial and bona fide business discussion during, directly preceding, or directly following the meal. However, in the case of an individual who is away from home in the pursuit of a trade or business and who eats alone, the absence of a business discussion does not preclude satisfying the "directly related" or "associated with" requirement.

For purposes of deducting meal expenses, the business discussion requirement (applying to any business meal other than one consumed alone by an individual who is away from home in the pursuit of a trade or business) is deemed not to have been met if neither the taxpayer nor any employee of the taxpayer is present at the meal. Thus, for example, if the taxpayer reserves a table at a business dinner but neither the taxpayer nor an employee of the taxpayer attends the dinner, no deduction will be allowed. Similarly, if one party to a contract negotiation buys dinner for other parties involved in the negotiations, but does not attend the dinner, the deduction is denied even if the other parties engage in a business discussion.[13]

For purposes of this rule, an independent contractor who renders significant services to the taxpayer (other than attending meals on the taxpayer's behalf, or providing services relating to meals) is treated as an employee, if he or she attends the meal in connection with such performance of services. Thus, for example, an attorney who was retained by a taxpayer to represent the taxpayer in a particular legal proceeding would be treated as an employee of the taxpayer for purposes of this rule, if the attorney represented the taxpayer at a business meal at which the legal proceeding was discussed.

Second, the bill provides that the cost of a business meal is not deductible unless the meal has a clear business purpose currently related to the active conduct of a trade or business. This require-

[13] However, the requirement that the taxpayer be present does not apply in the case of a transfer for business purposes of a packaged food or beverage item, such as a holiday turkey, ham, fruitcake, or bottle of wine.

ment is stricter than the generally applicable requirement for deducting meal and entertainment expenses (described above). Thus, the clear business purpose requirement is not satisfied in the case of a meal at which the business discussion does not concern a specific business transaction or arrangement. In addition, the cost of a meal is not deductible if it serves non-trade or business purposes of the taxpayer (e.g., investment purposes) rather than trade or business purposes and thus under present law would give rise to a deduction (if at all) under section 212 rather than section 162.

Third, the bill makes explicit that the statutory rule under present law disallowing deductions for certain lavish and extravagant travel expenses (including for meals) applies to all business meals. Thus, it applies whether or not the expense is incurred while the taxpayer is away from home, and whether or not the taxpayer incurs the expense alone or with others.

Finally, under the bill, to the extent that a taxpayer claims business meal deductions to which the taxpayer is not legally entitled, a special penalty rule applies if the error is negligent or fraudulent. If the erroneous deduction was due to negligence or disregard of rules and regulations, the otherwise applicable negligence penalty will not be less than 50 percent of the underpayment resulting from the improperly claimed deduction. If the error is due to fraud, the penalty equals 100 percent of the extra amount of tax due.

The rules of the bill reflect the committee's concerns about deductions claimed for meals that do not clearly serve business purposes or are not adequately substantiated. In keeping with these concerns, the committee expects the Treasury to adopt regulations providing, to the extent reasonable, stricter substantiation requirements for business meal deductions. For example, such regulations could relate to the need for documentary evidence, such as a restaurant receipt, substantiating business meal expenses, including expenses of less than $25 per day. The committee also emphasizes that, under present law, as well as under the bill, courts may not apply the so-called "Cohan rule," allowing approximation of the amount of an expense, to any business meal or other entertainment expense.

c. Deductions for tickets limited to face value

Under the bill, a deduction (if otherwise allowable) for the cost of a ticket for an entertainment activity is limited (prior to application of the 20 percent reduction rule) to the face value of the ticket. The face value of a ticket includes any amount of ticket tax on the ticket. Under this rule, a payment to a "scalper" for a ticket is not deductible (even if not disallowed under present law as an illegal payment) to the extent that the amount paid exceeds the face value of the ticket. Similarly, a payment to a ticket agency for a ticket is not deductible to the extent in excess of the face value of the ticket.

However, the face value limitation does not apply to an expense that is excepted under the bill from the percentage reduction rule because it relates to a sports event that meets certain requirements related to charitable fundraising (see description above).

d. Travel as a form of education

Under the bill, no deduction is allowed for travel as a form of education. This rule applies when a travel deduction would otherwise be allowable only on the ground that the travel itself serves educational purposes (for example, in the case of a teacher of French who travels to France in order to maintain general familiarity with the French language and culture). This disallowance rule does not apply when a deduction is claimed with respect to travel that is a necessary adjunct to engaging in an activity that gives rise to a business deduction relating to education (for example, where a scholar of French literature travels to Paris in order to do specific library research that cannot be done elsewhere, or to take courses that are offered only at the Sorbonne, in circumstances such that the nontravel research or course costs are deductible).

e. Expenses for nonbusiness conventions, etc.

Under the bill, no deduction is allowed for expenses related to attending a convention, seminar, or similar meeting unless such expenses are deductible under section 162 as ordinary and necessary expenses of carrying on a trade or business. Thus, the bill disallows deductions for expenses of attending a convention, etc. where the expenses, but for the provision in the bill, would be deductible under section 212 (relating to expenses of producing income) rather than section 162. The expenses to which the provision relates typically include such items as travel to the site of such a convention, fees for attending the convention, and personal living expenses, such as meals, lodging, and local travel, that are incurred while attending the convention or other meeting. This disallowance rule does not apply to expenses incurred by a taxpayer in attending a convention, seminar, sales meeting, or similar meeting relating to the trade or business of the taxpayer.

f. Luxury water travel

The bill also places limitations on allowable deductions for travel by ocean liner, cruise ship, or other form of luxury water transportation. This rule applies, for example, in the case of a taxpayer who has business reasons for traveling from New York City to London and who travels by ocean liner.

Under the bill, the deduction allowable in the case of luxury water travel cannot exceed twice the highest amount generally allowable with respect to a day of travel to employees of the executive branch of the Federal Government while away from home but serving in the United States, multiplied by the number of days the taxpayer was engaged in luxury water travel. For example, if during a particular taxable year the applicable Federal per diem amount is $75, a taxpayer's deduction for a six-day trip cannot exceed $900 ($150 per day times six days). The applicable per diem amount generally is the highest travel amount applying for an area in the conterminous United States; however, any limited special exception to this amount (e.g., a higher limit that applied only to high-ranking executive personnel) would be disregarded.

If the expenses of luxury water travel include separately stated amounts for meals or entertainment, the amounts so separately stated are reduced by 20 percent, under the percentage reduction rule, prior to application of this per diem limitation. However, in the absence of separately stated meal or entertainment charges, taxpayers are not required to allocate a portion of the total amount charged for luxury water travel to meals or entertainment unless the amounts to be allocated are clearly identifiable.

The per diem rule does not apply in the case of any expense allocable to a convention, seminar, or other meeting which is held on any cruise ship. Thus, the per diem rule does not alter the application of the present-law rule under which deductions for conventions held abroad cruise ships are wholly denied or, in certain special cases, allowed to the extent not in excess of $2,000 per individual. Under the bill, the statutory exceptions to the business meal percentage reduction rule (described above) are also exceptions to the per diem rule with respect to luxury water travel.

g. Foreign convention rules

The bill provides that Bermuda is to be treated as part of the North American area for purposes of the foreign convention deduction rules in section 274(h) if the President certifies (1) that such treatment is in the national security interest of the United States, and (2) that the information exchange policies of Bermuda do not materially impede the administration and enforcement of U.S. tax laws.[14] However, if a certification is made within one year of enactment of the bill, the second requirement for certification (relating to U.S. tax laws) does not apply.

Any such certification by the President takes effect when published in the Federal Register and remains effective until the third anniversary of the publication date. If such a certification is in effect, business deductions for conventions held in Bermuda are not subject to the rules set forth in section 274(h)(1).

Effective Date

The provisions are effective for taxable years beginning after December 31, 1986.

Revenue Effect

The provisions are estimated to increase fiscal year budget receipts by $1,208 million in 1987, $2,043 million in 1988, $2,317 million in 1989, $2,705 million in 1990, and $2,987 million in 1991.

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[14] Conforming amendments to secs. 274(h)(6)(C) and (E) are made by the bill.

2. Repeal of miscellaneous itemized deductions; modifications to certain employee business expense deductions (secs. 132-33 of the bill and sec. 62 and new secs. 280H and 280I of the Code)

Present Law

In general

The list of itemized deductions on Schedule A of Form 1040 includes a category labeled miscellaneous deductions, following the listings for medical expenses, charitable expenses, interest, taxes, and casualty and theft losses. Under present law, this category generally includes four types of deductions: (1) certain employee business expenses (sec. 162); (2) expenses of producing income (sec. 212); (3) expenses related to filing tax returns (sec. 212); and (4) expenses of adopting children with special needs (sec. 222).

Employee business expenses

An employee business expense is a cost incurred by an employee in the course of performing his or her job. Examples of such costs include unreimbursed expenditures for subscriptions to professional journals or continuing education courses, union or professional dues, costs of professional uniforms, costs of looking for new employment, and expenses allowable for business use of the taxpayer's home. Ordinary and necessary employee business expenses generally are deductible.

Employee business expenses generally can be claimed only as itemized deductions. However, under present law four types of employee business expenses are deductible above-the-line in calculating adjusted gross income, and thus are directly available to nonitemizers: (1) certain expenses paid by an employee and reimbursed by the employer; (2) employee travel expenses incurred while away from home; (3) employee transportation expenses incurred while on business; and (4) business expenses of employees who are outside salespersons (sec. 62(2)).[15]

Certain deductions for employee business expenses also are subject to specific limitations or restrictions. For example, a taxpayer's business use of his or her home (whether or not the taxpayer is in the business of being an employee) does not give rise to a deduction for the business portion of expenses related to operating the home (e.g., rent, depreciation, and repairs) unless the taxpayer uses a part of the home regularly and exclusively as the principal place of business or as a place of business used by patients, clients, or customers (sec. 280A).[16] Educational expenses are deductible only if the education (1) is required by the employer, by law, or by regulations, or (2) maintains or improves skills required to perform the taxpayer's present occupation. Costs of looking for new employ-

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[15] For this purpose, the term outside salesperson means an individual who solicits business as a full-time salesperson for his or her employer away from the employer's place of business. The term outside salesperson does not include a taxpayer whose principal activities consist of service and delivery, such as a bread driver-salesperson. However, an outside salesperson may perform incidental inside activities at the employer's place of business, such as writing up and transmitting orders and spending short periods at the employer's place of business to make and receive telephone calls (Treas. Reg. sec. 1.62-1(h)).

[16] See secs. 143(b) and 143(c) of the bill, amending the rules relating to home office deductions.

ment are deductible only if they relate to employment in the taxpayer's present occupation.

Investment expenses

In general, expenses of producing income other than rental or royalty income are treated as itemized deductions if the related activity does not constitute a trade or business. (Trade or business expenses and expenses of producing rental or royalty income are deductible above-the-line.) Among the types of investment expenses that may be eligible, in particular circumstances, for deduction are investment counsel and trust administration fees, subscriptions to investment advisory publications, and attorneys' fees incurred in collecting income.

Other miscellaneous itemized deductions

Tax counsel and assistance fees, as well as appraisal fees paid to determine the amount of a casualty loss or a charitable contribution of property, may be claimed as itemized deductions (sec. 212(3)).

Expenses incurred with respect to a hobby—i.e., an activity that may generate some gross income but that the taxpayer conducts for personal recreational reasons, rather than with the goal of earning a profit—are deductible to the extent such expenses would be deductible regardless of profit motivation (e.g., certain interest and taxes) or to the extent of income from the hobby.[17] Gambling losses are deductible as itemized deductions to the extent of gambling gains.

Reasons for Change

The committee believes that, as part of the approach of its bill to reduce tax rates through base-broadening, it is appropriate to repeal the miscellaneous itemized deductions and to limit deductions for certain employee expenses. The committee also concluded that allowance of these deductions under present law fosters significant complexity, and that some of these expenses have characteristics of voluntary personal expenditures.

For taxpayers who anticipate claiming itemized deductions, present law effectively requires extensive recordkeeping with regard to what commonly are small expenditures. Moreover, the fact that small amounts typically are involved presents significant administrative and enforcement problems for the Internal Revenue Service. These problems are exacerbated by the fact that taxpayers may frequently make errors of law regarding what types of expenditures are properly allowable as miscellaneous itemized deductions.[18]

Moreover, some miscellaneous expenses allowable under present law are sufficiently personal in nature that they would have been

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[17] See sec. 143(a) of the bill, amending the rules relating to hobby losses.

[18] Common taxpayer errors include disregarding the restrictions on home office deductions, and on the types of education expenses that are deductible; claiming a deduction for safe deposit expenses even if used only to store personal belongings; and deducting the cost of subscriptions to widely read publications outlining business information without a sufficient business or investment purpose.

incurred apart from any business or investment activities of the taxpayer. For example, membership dues paid to professional associations may both serve business purposes and also have voluntary and personal aspects; similarly, subscriptions to publications may help taxpayers in conducting a profession and also may convey personal and recreational benefits. Taxpayers presumably would rent safe deposit boxes to hold personal belongings such as jewelry even if the cost, to the extent related to investment assets such as stock certificates, were not deductible.

The committee believes that generally it is appropriate to disallow deductions for employee business expenses because employers reimburse employees for those expenses that are most necessary for employment. The committee has retained deductions for unreimbursed employee travel and transportation expenses, and outside salesperson expenses, because they may be incurred in situations where reimbursement might not be possible (e.g., travel between two jobs). However, the committee believes that these amounts should be deductible only as itemized deductions, subject to a floor of one percent of adjusted gross income. The floor will contribute to simplification by relieving individuals of the burden of recordkeeping unless they expect to incur such expenditures in excess of the percentage floor. Also, the floor will relieve the Internal Revenue Service of the burden of auditing deductions for such expenditures when not significant in aggregate amount.

Explanation of Provisions

The bill disallows the miscellaneous deductions allowed under present law on Schedule A, lines 20-23, *other than* (1) the deduction for certain costs of adopting children with special needs (sec. 222), (2) the deduction for estate tax in the case of income in respect of a decedent (sec. 691(c)), (3) the deduction for gambling losses up to, but not exceeding, gambling income (sec. 165(d)), and (4) the adjustment deduction where a taxpayer restores certain amounts held under claim of right (sec. 1341).

In addition, the bill provides that employee travel and transportation expenses deductible under present law pursuant to sections 62(2)(B) and (C), and expenses of outside salespersons deductible under present law pursuant to section 62(2)(D)), are allowable only as itemized deductions and only to the extent that the aggregate of such expenses of the taxpayer exceeds one percent of adjusted gross income.[19]

Effective Date

The provisions apply to taxable years beginning after December 31, 1986.

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[19] The bill does not modify the above-the-line deduction under sec. 62(2)(A) for certain reimbursed expenses of an employee under a reimbursement or other expense allowance with his or her employer. (The Treasury may prescribe regulations under which expenses of an employee reimbursed by a third party are to be treated as expenses described in sec. 62(2)(A).) If the employee has a reimbursement or other expense allowance arrangement with his or her employer but under the arrangement the employer does not reimburse the full amount of such expenses, the unreimbursed portion paid by the employee is allowable only to the extent (if any) allowable under sec. 132 of the bill as an itemized deduction, and subject to the one-percent floor provided in sec. 133 of the bill.

Revenue Effect

The provisions are estimated to increase fiscal year budget receipts by $853 million in 1987, $5,578 million in 1988, $5,040 million in 1989, $5,468 million in 1990, and $5,932 million in 1991.

3. Changes in treatment of hobby losses (sec. 143(a) of the bill and sec. 183 of the Code)

Present Law

Expenses arising from hobbies (i.e., activities not engaged in for profit) are allowed only as itemized deductions. Except for expenses that are deductible without reference to whether they are incurred in an activity designed to produce income (i.e., certain interest and taxes), hobby expenses are deductible only to the extent not exceeding the amount of hobby income for the year (Code sec. 183). These rules apply, for example, to activities such as horse-breeding, farming, and researching a restaurant or travel guide, if the taxpayer's motivations are recreational rather than profit-oriented.

A facts and circumstances test generally applies to determine whether a particular activity constitutes a hobby. However, statutory rules provide that if the gross income from an activity exceeds the deductions attributable thereto for two or more out of five consecutive years (seven consecutive years in the case of an activity which consists in major part of the breeding, training, showing, or racing of horses), then the activity is presumed to be engaged in for profit rather than as a hobby. The presumption that an activity is not a hobby if it is profitable in two out of five consecutive years (or seven consecutive years, for certain activities) can be overcome by the Internal Revenue Service under the general facts and circumstances test.

Reasons for Change

The committee is concerned that the statutory presumption under present law regarding whether an activity is being engaged in for profit may unduly benefit some taxpayers who engage in activities as hobbies, but who can structure their earnings and expenses so as to realize a profit in at least two out of five consecutive years. For example, the presumption can apply even if the taxpayer realizes a substantial net loss over five years that reflects a willingness to incur losses as the cost of personal recreation, rather than unexpected business difficulties. Even though the Internal Revenue Service can overcome the statutory presumption, some abuse nonetheless may arise, in light of the subjective nature of a general facts and circumstances test. However, in the case of horse breeding, training, showing, and racing activities, the committee believes that the present-law rules should continue to apply.

Explanation of Provision

Under the bill, for activities other than those consisting in major part of horse breeding, training, showing, or racing, the statutory presumption of being engaged in for profit applies only if the activity is profitable in three out of five consecutive years.

As in the case of other expenses that under present law are deductible as miscellaneous itemized deductions, deductions for hobby expenses—other than costs that are deductible without reference to whether they are incurred in an activity designed to produce income (such as certain taxes)—are disallowed under section 132 of the bill.

Effective Date

The provision is effective for taxable years beginning after December 31, 1986.

Revenue Effect

The provision relating to the statutory presumption is estimated to increase fiscal year budget receipts by a negligible amount.

4. Changes in deduction for business use of home (secs. 143(b) and (c) of the bill and sec. 280A of the Code)

Present Law

In general

A taxpayer's business use of his or her home may give rise to a deduction for the business portion of expenses related to operating the home (e.g., rent, depreciation, and repairs). However, deductions are allowed only with respect to a part of the home that is used exclusively and regularly either as the principal place of business of the taxpayer or as a place of business to meet patients, clients, or customers (Code sec. 280A), or if the part of the home used for business purposes constitutes a separate structure. In the case of an employee, a further requirement for a deduction is that the business use of the home must be for the convenience of the employer.

For employees, deductions for depreciation or operating expenses of a home allowable under these rules generally must be claimed as itemized deductions. If an employee receives employer reimbursements for home office costs and includes the reimbursements in gross income, the home office expenses generally are reported on Form 2106 and deductible "above-the-line" as an adjustment to gross income; an employee who constitutes an "outside" salesperson (sec. 62(2)(D)) similarly deducts such amounts above-the-line. Self-employed persons claim any allowable deductions for home office expenses above-the-line on Schedule C.

Rental use of home

These general business-use requirements need not be met in the case of rental use of a part of the home (e.g., when the taxpayer rents a room to a lodger). In a recent Tax Court case, *Feldman* v. *Comm'r*, 84 T.C. 1 (1985), this rental exception was applied, and the general requirements for the deduction held inapplicable, where an employer nominally rented a portion of the employee's home used by the employee in performing services for the employer. The court permitted the taxpayer to deduct home office expenses without requiring regular and exclusive use of the home either as the taxpay-

er's principal place of business or as a place to meet patients, clients, or customers, notwithstanding the court's finding that the rental was not an arm's length arrangement and was made for more than the fair rental value of the space that nominally was rented.

Limitations on deduction

Deductions for home office costs that are allowed solely because there is a qualifying business use of the home are limited to the amount of the taxpayer's gross income derived from the business use of the home during the taxable year. Costs in excess of the limitation cannot be carried over and used as deductions in other taxable years. This limitation has no effect on deductions (such as home mortgage interest and real property taxes) that are allowable in the absence of business use.

The Internal Revenue Service has issued proposed regulations defining gross income derived from the business use of the home as gross income from the business activity in the unit reduced by expenditures required for the activity but not allocable to the use of the unit itself, such as expenditures for supplies and compensation paid to other persons.[20] However, in *Scott* v. *Comm'r*, 84 T.C. 683 (1985), the Tax Court rejected this interpretation, holding that gross income from the use of the home means gross income from the business activity itself, i.e., not reduced by any outside expenditures required for the activity.

Under the Tax Court's interpretation, deductions for business use of one's home could be used to create or increase a net loss from the activity and thus, in effect, to offset income from unrelated activities. For example, assume that a taxpayer derived gross income of $1,000 from an activity, and incurred expenses of $1,500 that related to the activity but that did not relate to use of the home (e.g., expenses for supplies, secretaries, and messengers). Under the Tax Court's interpretation, the taxpayer would be permitted to deduct up to $1,000 in home office costs that are not otherwise deductible (e.g., rent or depreciation), despite the fact that there was no net income from the activity.

Reasons for Change

The provisions of the committee bill that repeal the present-law miscellaneous itemized deductions claimed on Schedule A of Form 1040, and that place limitations on deductions for certain employee business expenses that under present law are allowable above-the-line, partially alleviate concerns of the committee about the rules governing home office deductions claimed by employees. However, to the extent home office expenses remain deductible by self-employed persons or certain employees, the committee believes that the following modifications to the deductibility of such expenses are desirable.

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[20] Proposed Treas. Reg. sec. 1.280A-2(i)(2)(iii), 48 Fed. Reg. 33325 (July 21, 1983).

Requirements for deduction

The committee believes that taxpayers should not be able to circumvent the limitations on home office deductions by arranging for their employers to rent portions of their homes. The allowance of such arrangements would significantly narrow the applicability of section 280A and could encourage tax avoidance of the sort that that section was intended to prevent.

Section 280A was enacted because of concerns that some taxpayers were converting nondeductible personal and living expenses into deductible business expenses simply because they found it convenient to perform some work at home.[21] The committee recognizes that in some instances a legitimate cost resulting from business use of a home could conceivably be disallowed under the restrictions of section 280A; however, any such instances would be difficult to identify and define.

Further, the committee believes that allowing deductions for use of a taxpayer's residence inherently involves the potential for abuse. In enacting section 280A, the Congress concluded that absent limitations, taxpayers could claim home office deductions even when no marginal cost of maintaining the home was incurred by the taxpayer as a result of the business use. Thus, the Congress concluded that home office deductions should be disallowed in the absence of specified circumstances indicating a compelling reason for business use of the home, and in any event should not be permitted to offset taxable income derived from unrelated activities.

Under the interpretation of section 280A applied by the Tax Court in the *Feldman* decision, the committee believes the statute would fail to achieve its intended purpose. Allowing employees to use lease arrangements with employers as a method of circumventing the restrictions on home office deductions might encourage some taxpayers to arrange sham transactions whereby a portion of salary is paid in the form of rent. Moreover, it is questionable whether lease transactions between an employer and employee are generally negotiated at arm's length, particularly if such a transaction could provide added tax deductions to the employee at no additional cost to the employer. Accordingly, the committee believes that no home office deductions should be allowable (except for expenses such as home mortgage interest and real property taxes that are deductible absent business use) if the employee rents a portion of his or her home to the employer.

Limitations on deduction

In general.—The *Scott* decision would permit taxpayers to use home office deductions to create or increase a net loss from the business activity, and thus to offset unrelated income. The committee believes that a home office deduction to which section 280A applies should not be used to reduce taxable income from the activity to less than zero. In adopting the provisions of the bill, the committee reemphasizes that section 280A was enacted because of concerns about allowing deductions for items which have a substantial

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[21] See Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1976* (JCS-33-76), at 139.

personal component relating to the home, which most taxpayers cannot deduct, and which frequently do not reflect the incurring of significantly increased costs as a result of the business activity, and that the provision should be interpreted to carry out its objectives.

Carryover.—Finally, the committee believes that the application of section 280A under present law may be unduly harsh in one respect. Deductions that are disallowed because they exceed the statutory limitation (i.e., the amount of income from the business activity) cannot be carried forward to subsequent taxable years and claimed to the extent of subsequent income from the activity. However, since the purpose of this limitation is to deny the use of home office deductions to offset unrelated income, the committee believes that deduction carryforwards should be allowed, subject to the general limitation that the home office deductions in any year cannot create or increase a net loss from the business activity.

Explanation of Provisions

Requirements for deduction

The bill provides that no home office deduction is allowable by reason of business use where an employee leases a portion of his or her home to the employer.[22] For this purpose, an individual who is an independent contractor is treated as an employee, and the party for whom such individual is performing services is treated as an employer. In the case of a lease that is subject to this rule, no home office deductions are allowed except to the extent that they would be allowable in the absence of any business use (e.g., home mortgage interest expense and real property taxes).

Limitations on deduction

In general.—The bill limits the amount of a home office deduction (other than expenses that are deductible without regard to business use, such as home mortgage interest) to the taxpayer's gross income from the activity, reduced by all other deductible expenses attributable to the activity but not allocable to the use of the unit itself. Thus, home office deductions are not allowed to the extent that they create or increase a net loss from the business activity to which they relate.

Carryover.—The bill provides a carryforward for those home office deductions that are disallowed solely due to the income limitation on the amount of an otherwise allowable home office deduction. Deductions that meet the general requirements of section 280A but that are disallowed solely because of the income limitation may be carried forward to subsequent taxable years, subject to the continuing application of the income limitation to prevent the use of such deductions to create or increase a net loss in any year from the business activity.

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[22] Also, payments to an employee from his or her employer that constitute wages are not exempted from withholding requirements and employment taxes merely because the employer and employee label such payments as "rent" under a "rental" or "lease" agreement.

Effective Date

The provision is effective for taxable years beginning after December 31, 1986.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by a negligible amount.

G. Repeal of Political Contributions Tax Credit (Sec. 112 of the bill and sec. 24 of the Code)

Present Law

Individual taxpayers may claim a nonrefundable income tax credit equal to one-half the amount of their contributions during the year to political candidates and certain political campaign organizations (Code sec. 24). The maximum allowable credit is $50 for an individual and $100 for a married couple filing a joint return.

Reasons for Change

The committee believes that, as part of the approach of its bill to reduce tax rates through base-broadening, it is appropriate to repeal the political contributions tax credit. The committee also understands that data compiled by the IRS suggest that a significant percentage of persons claiming the credit have sufficiently high incomes to make contributions in after-tax dollars, without the benefit of the credit. Also, the credit provides no incentive for individuals with no income tax liability for the year. The small credit amount allowable per return under the dollar limitations makes verification costly in relation to the tax liability at issue.

Explanation of Provision

The bill repeals the credit for political contributions.

Effective Date

The provision is effective for taxable years beginning after December 31, 1986.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $327 million in 1988, $341 million in 1989, $354 million in 1990, and $368 million in 1991.

TITLE II—ACCELERATED COST RECOVERY SYSTEM AND INVESTMENT TAX CREDIT

Cost Recovery Provisions: Depreciation, the Regular Investment Tax Credit, and Finance Leases (secs. 201, 202, and 211 of the bill and secs. 38, 46, 57, 168, 178, 179, 312(k), 1245, 1250, and new sec. 49 of the Code)

Present Law

Overview

The Economic Recovery Tax Act of 1981 ("ERTA") enacted the Accelerated Cost Recovery System ("ACRS") for tangible depreciable property placed in service after 1980. Under ACRS, the cost or other basis of eligible property (without reduction for salvage value) is recovered using an accelerated method of depreciation over a predetermined recovery period (sec. 168). Under prior law, an asset's cost (less salvage value) was recovered over its estimated useful life (sec. 167). Prior law rules remain in effect for property placed in service by a taxpayer before 1981, and for property not eligible for ACRS.

ACRS

Under ACRS, the allowable recovery deduction in each recovery year is determined by applying a statutory percentage to the property's original cost (adjusted, as described below, for investment tax credit allowed) (sec. 168(b)(1)).

Personal property

The statutory percentages for personal property are based on the 150-percent declining balance method for the early recovery years, switching to the straight-line method at a time to maximize the recovery allowance. Alternatively, taxpayers can elect to use the straight-line method over the applicable ACRS recovery period (or over a longer recovery period) with respect to one or more classes of ACRS property placed in service during a taxable year (sec. 168(b)(3)(A)). Under a "half-year" convention, the statutory tables and straight-line alternatives provide a half-year recovery allowance for the first recovery year, whether the property is placed in service early or late in the year. No recovery allowance is allowed in the taxable year in which the taxpayer disposes of the asset.

The cost of eligible personal property is recovered over a three-year, five-year, 10-year, or 15-year recovery period, depending on the recovery class of the property.

The classification of personal property under ACRS generally is based on the Asset Depreciation Range ("ADR") system of prior law. Under the ADR system, a present class life ("midpoint") was provided for all assets used in the same activity, other than certain

assets with common characteristics (*e.g.*, automobiles). Property with an ADR midpoint life of four years or less (such as automobiles, light general purpose trucks, certain special tools, and over-the-road tractor units), racehorses more than two years old when placed in service, other horses more than 12 years old when placed in service, and property used in connection with research and experimentation are included in the three-year class. The 10-year class includes long-lived public utility property with an ADR midpoint life from 18.5 to 25 years, certain burners and boilers, and railroad tank cars. Longer-lived public utility property having an ADR midpoint life over 25 years is in the 15-year class. Personal property not included in any other class is assigned to the five-year class.

Taxpayers are required to reduce the basis of assets by 50 percent of the amount of regular or energy investment tax credits allowed with respect to personal property (and the reduced basis is used to compute recovery deductions) (sec. 48(q)(1)). With respect to the regular investment tax credit, a taxpayer can elect a 2-percentage point reduction in the credit in lieu of the half-basis adjustment (sec. 48(q)(4)).

Real property

The statutory percentages for real property are based on the 175-percent declining balance method (200-percent for low-income housing described in section 1250(a)(1)(B)(i)-(iv)), switching to the straight-line method at a time to maximize the deduction (sec. 168(b)(2) and (4)). For the year of acquisition and disposition of real property, the recovery allowances are based on the number of months during those years that the property is in service. Under a "mid-month" convention, real property (other than low-income housng) placed in service or disposed of by a taxpayer at any time during a month is treated as having been placed in service or disposed of in the middle of the month.

For real property placed in service after May 8, 1985, the cost is recovered over a 19-year recovery period (15 years for low-income housing), although longer recovery periods may be elected (sec. 168(b)(2) and (4)).

Generally, low-income housing includes projects eligible for various Federal, State, and local housing programs and projects where 85 percent of the tenants are eligible for, but do not necessarily receive, subsidies under Section 8 of the Housing Act of 1937.

Under ACRS, component cost recovery is not permitted. Thus, the same recovery period and method must be used for a building as a whole, including all structural components. A substantial improvement (generally, one that is made over a two-year period at a cost that is at least 25 percent of a building's unadjusted basis) is treated as a separate building, the cost of which must be separately recovered when the improvement is placed in service.

If the 15-percent or 20-percent investment tax credit for rehabilitation expenditures is allowed, the basis of real property is reduced by the amount of credit earned (and the reduced basis is used to compute recovery deductions) (sec. 48(q)(1) and (3)). The basis of real property is reduced by 50 percent of the 25-percent credit allowed for the rehabilitation of a certified historic structure (sec.

48(q)(1)). In addition, if a credit for rehabilitation expenditures is allowed, the straight-line method of cost recovery must be used with respect to the rehabilitation expenditures.

Recapture

With certain limited exceptions, gain from the disposition of depreciable property is "recaptured" as ordinary income to the extent of previously allowed ACRS deductions (sec. 1245). For residential real property that is held for more than one year, gain is treated as ordinary income only to the extent the depreciation deductions allowed under the prescribed accelerated method exceed the deductions that would have been allowed under the straight-line method (sec. 1250(b)(1)). In addition, recapture for qualified low-income housing is phased out after such property has been held for a prescribed number of months, at the rate of one percentage point per month (sec. 1250(a)(1)(B)). For nonresidential real property held for more than one year, there is no recapture if the taxpayer elected to recover the property's cost using the straight-line method over the applicable ACRS recovery periods (sec. 1245(a)(5)(C)). If accelerated depreciation is claimed with respect to nonresidential real property, the full amount of the depreciation deductions previously taken (to the extent of gain) is recaptured. Because the benefits of capital gains treatment on gains attributable to previously claimed depreciation often exceed the additional benefit derived from accelerated depreciation, investors frequently choose to claim straight-line depreciation on nonresidential real property.

Application of different depreciation methods for certain purposes

In general, ACRS recovery allowances are reduced for property that is (1) used predominantly outside the United States ("foreign-use property") (sec. 168(f)(2)), (2) leased to a tax-exempt entity, including a foreign person—unless more than 50 percent of the gross income derived from the property is subject to U.S. tax—("tax-exempt use property") (sec. 168(j)), or (3) financed with industrial development bonds the interest on which is exempt from taxation (sec. 168(f)(12)).

Different depreciation methods are also used for purposes of computing earnings and profits of a domestic corporation and applying the minimum tax provisions.

Foreign-use property.—The rationale for reducing ACRS deductions for foreign-use property is that the investment incentive is intended to encourage capital investment in the United States and should not be available to property used predominantly outside the United States. The recovery period for foreign-use personal property is equal to the asset's ADR midpoint life (12 years for property without a midpoint life), and the 200-percent declining balance method may be used. The recovery period for foreign-use real property is 35 years, and the 150-percent declining balance method may be used. A taxpayer may elect to use the straight-line method over the applicable recovery period or certain longer periods.

Communications satellites, as defined in Code section 48(a)(2)(B), are excluded from the definition of foreign-use property. Other

spacecraft (and interests therein) are not specifically excluded from the definition of foreign-use property.

Tax-exempt use property.—The policy underlying the restriction on tax-exempt use property is to provide tax-reducing incentives only to those who are subject to income tax, and to deny them to tax-exempt entities, including foreign entities.

Depreciation deductions for tax-exempt use property are computed using the straight-line method and disregarding salvage value. The cost of tax-exempt use personal property is generally recovered over the longer of the asset's ADR midpoint life (12 years if the property has no ADR midpoint life) or 125 percent of the lease term. The recovery period for qualified technological property subject to these rules is five years. The recovery period for tax-exempt use real property is the longer of 40 years or 125 percent of the lease term. A taxpayer may elect to recover the cost of tax-exempt use property over an optional extended recovery period. The rules for tax-exempt use property override the rules relating to foreign-use property.

Property financed with industrial development bonds.—Except in the case of property that is placed in service in connection with projects for residential rental property, the cost of property that is financed with tax-exempt industrial development bonds is recovered using the straight-line method over either the applicable ACRS recovery period or an optional extended recovery period (sec. 168(f)(12)).

Computation of earnings and profits.—If an accelerated depreciation method were used for purposes of computing earnings and profits, the acceleration of depreciation deductions would reduce a corporation's earnings and profits, and thereby facilitate the distribution of tax-free dividends. For this reason, domestic corporations are required to compute earnings and profits using the straight-line method over recovery periods that are longer than the standard ACRS recovery periods (sec. 312(k)(3)).

The extended recovery periods used to compute earnings and profits are: (1) five years for three-year property, (2) 12 years for five-year property, (3) 25 years for 10-year property, (4) 35 years for 15-year public utility property, and (5) 40 years for 19-year real property and low-income housing.

Minimum taxes.—The minimum tax provisions are designed to prevent taxpayers with substantial economic income from avoiding tax liability by using certain exclusions, deductions, and credits (referred to as "items of tax preference"). In applicable cases, the excess of ACRS deductions over depreciation deductions that would have been allowed had the taxpayer used the straight-line method over a prescribed recovery period is treated as an item of tax preference. For purposes of this rule, the prescribed recovery periods are: (1) five years for three-year property, (2) eight years for five-year property, (3) 15 years for 10-year property, (4) 22 years for 15-year public utility property, (5) 15 years for low-income housing, and (6) 19 years for real property other than low-income housing. These rules apply only with respect to personal property subject to a lease and 19-year real property and low-income housing (sec. 57(a)(12)). Further, personal property subject to a lease is not taken

into account for corporations other than personal holding companies (as defined in sec. 542).

Luxury automobiles and mixed-use property.—ACRS deductions are subject to fixed limitations for automobiles and are reduced for certain property (including automobiles) that is used for both personal and business purposes (sec. 280F). For luxury automobiles, depreciation deductions are limited to $3,200 for the first year in the recovery period, and $4,800 for each succeeding year. For mixed-use property that is used 50 percent or more for personal purposes, capital costs are recovered using the straight-line method of depreciation over the same recovery periods that are used for purposes of computing the earnings and profits of a domestic corporation. ACRS is available for mixed-use property that is used more than 50 percent for business purposes, but only with respect to the portion of the property's basis that is attributable to business use.

Mass asset vintage accounts

In general, taxpayers compute depreciation deductions, as well as gain or loss on disposition, on an asset-by-asset basis. A taxpayer can elect to establish mass asset vintage accounts for assets that are in the same recovery class and placed in service in the same taxable year. Under proposed Treasury regulations, the definition of mass assets eligible for this treatment would be limited to assets (1) each of which is minor in value relative to the total value of such assets, (2) that are numerous in quantity, (3) that are usually accounted for only on a total dollar or quantity basis, and (4) with respect to which separate identification is impractical (Prop. Treas. reg. sec. 1.168-2(h)(2)).

Lessee-leasehold improvements

In general, if a lessee makes improvements to property, the lessee is entitled to recover the cost of the improvement over the shorter of the ACRS recovery period applicable to the property or the portion of the term of the lease remaining on the date the property is acquired. If the remaining lease term is shorter than the recovery period, the cost is amortized over the remaining term of the lease. For purposes of these rules, under section 178, if the remaining term of a lease is less than 60 percent of the improvement's ACRS recovery period, the term of a lease is treated as including any period for which the lease may be renewed pursuant to an option exercisable by the lessee, unless the lessee establishes that it is more probable that the lease will not be renewed (sec. 178(a)). In any case, a renewal period must be taken into account if there is a reasonable certainty the lease will be renewed (sec. 178(c)). Section 178 also provides rules relating to the amortization of lease acquisition costs.

Public utility property

In general, a regulatory commission allows a public utility to charge customers rates that are sufficient to recover the utility's cost of service. A public utility's cost of service includes its annual operating expense and the capital expense allocable to a year. The capital expense that can be passed through as higher prices to customers consists of an annual depreciation charge for equipment

and also a rate of return on the capital invested in the equipment and other property (which capital is referred to as the "rate base").

ACRS distinguishes between long-lived public utility equipment and other equipment. Further, as described below, public utilities are required to use a "normalization" method of accounting for ACRS deductions (sec. 168(e)(3)).

Definition of public utility property.—In general, public utility property is property used predominantly in the trade or business of furnishing or selling:

(1) electrical energy, water, or sewage disposal services,

(2) gas or steam through a local distribution system,

(3) telephone services,

(4) other communication services if furnished or sold by the Communications Satellite Corporation for purposes authorized by the Communications Satellite Act of 1962 (47 U.C.C. sec. 701), or

(5) transportation of gas or steam by pipeline,

if the rates are established or approved by certain regulatory bodies (secs. 168(e)(3)(A) and 167(l)(3)(A)).

Normalization accounting.—A public utility can use ACRS only if a "normalization" method of accounting is used for purposes of establishing the utility's cost of service and reflecting operating results in its regulated books of account. Normalization requires that (1) a utility's tax expense for ratemaking purposes must be computed as if the depreciation deduction were computed in the same manner as the ratemaking allowance for depreciation (which is generally based on the straight-line method over relatively long useful lives), (2) the deferred taxes (i.e., the difference between the actual tax expense computed using ACRS and that computed for ratemaking purposes) must be reflected in a reserve (and thus be available for capital investment), and (3) the regulatory commission may not exclude from the rate base an amount that is greater than the amount of the reserve for the period used in determining the tax expense as part of the utility's cost of service (*see* Treas. reg. sec. 1.167(l)-1, which interprets a similar provision of prior law).

Normalization prevents the immediate lowering of rates charged to customers as a result of the cost savings from ACRS. Rather, current tax reductions are flowed through to customers over the period of tax deferral.

Expensing of up to $5,000 of personal property

A taxpayer (other than a trust or estate) can elect to deduct the cost of up to $5,000 of qualifying personal property in the year the property is placed in service, in lieu of recovering the cost under ACRS (sec. 179). In general, qualifying property must be acquired by purchase for use in a trade or business, and must be eligible for the investment tax credit (although no investment credit is allowed for the portion of the cost expensed under this rule). The $5,000 limit is scheduled to increase to $7,500 for taxable years beginning in 1988 and 1989, and to $10,000 for years beginning after 1989.

If expensed property is converted to nonbusiness use within two years of the time the property was placed in service, the difference between the amount expensed and the ACRS deductions that would have been allowed for the period of business use is recaptured as ordinary income.

Anti-churning rules

Under rules enacted as part of ACRS, taxpayers are prevented from bringing property placed in service before January 1, 1981 under ACRS by certain post effective date transactions (referred to as "churning transactions"). In general, churning transactions include those in which either the owner or user of property before January 1, 1981 (or a related party) is the owner or user immediately after the transaction. Taxpayers subject to the anti-churning rules compute depreciation under the law in effect before 1981.

Regular investment tax credit

General rule

A credit against income tax liability is allowed for up to 10 percent of a taxpayer's investment in certain tangible depreciable property (generally, not including buildings or their structural components) (secs. 38 and 46). The amount of the regular investment credit is based on the ACRS recovery class to which the property is assigned. The 10-percent credit is allowed for eligible property in the five-year, 10-year, or 15-year public utility property class. Three-year ACRS property is eligible for a six-percent regular credit (even if the taxpayer elects to use a longer recovery period). The maximum amount of a taxpayer's investment in used property that is eligible for the regular investment credit is $125,000 per year; the limitation on used property is scheduled to increase to $150,000 for taxable years beginning after 1987.

Generally, the investment credit is claimed for the taxable year in which qualifying property is placed in service. In cases where property is constructed over a period of two or more years, an election is provided under which the credit may be claimed on the basis of qualified progress expenditures ("QPEs") made during the period of construction before the property is completed and placed in service. Investment credits claimed on QPEs are subject to recapture if the property fails to qualify for the investment credit when placed in service.

The amount of income tax liability that can be reduced by investment tax credits in any year is limited to $25,000 plus 85 percent of the liability in excess of $25,000 (sec. 38(c)). Unused credits for a taxable year can be carried back to each of the three preceding taxable years and then carried forward to each of the 15 following taxable years (sec. 39).

Public utility property

Public utility property is eligible for the regular investment credit only if the tax benefits of the credit are normalized in setting rates charged by the utility to customers and in reflecting operating results in regulated books of account (sec. 46(f)). The investment credit is denied for public utility property if the regulatory commission's treatment of the credit results in benefits being flowed through to customers more rapidly than under either (1) the ratable flow-through method or (2) the rate base reduction method.

Under the ratable flow-through method (sec. 46(f)(2)), utilities pass through to customers a pro rata portion of the credit during each year of the useful life of the asset. The regulatory commission

may not require that the utility reduce its rate base by the amount of the credit. Therefore, even though the credit itself is flowed through to customers over the life of the asset, the utility's shareholders are allowed to earn a return on that amount of the cost of the equipment which has, in effect, been supplied by the Federal government through the regular investment credit.

Under the rate base reduction method (sec. 46(f)(1)), the utility's rate base is reduced by the amount of the credit, so that the shareholders are prevented from earning a return on that part of the cost of the equipment which is, in effect, paid for by the credit. Under this method, the regulatory commission may not require that the utility flow through to customers any part of the credit itself, and it must allow the utility to charge customers for the depreciation expense on the entire cost of the equipment, including the part paid for by the investment credit.

Finance leases

Overview

The law contains rules to determine who owns an item of property for tax purposes when the property is subject to an agreement which the parties characterize as a lease. Such rules are important because the owner of the property is entitled to claim tax benefits including cost recovery deductions and investment tax credits with respect to the property. These rules attempt to distinguish between true leases, in which the lessor owns the property for tax purposes, and conditional sales or financing arrangements, in which the user of the property owns the property for tax purposes. These rules generally are not written in the Internal Revenue Code. Instead they evolved over the years through a series of court cases and revenue rulings and revenue procedures issued by the Internal Revenue Service. Essentially, the law is that the economic substance of a transaction, not its form, determines who is the owner of property for tax purposes. Thus, if a transaction is, in substance, simply a financing arrangement, it is treated that way for tax purposes, regardless of how the parties choose to characterize it. Under these rules, lease transactions cannot be used solely for the purpose of transferring tax benefits. They have to have nontax economic substance.

Finance lease provisions

The Tax Equity and Fiscal Responsibility Act of 1982 provided rules (finance leasing rules) that liberalized the leasing rules with respect to certain property. Under the finance leasing rules, the fact that (1) the lessee has an option to purchase the property at a fixed price of 10 percent or more of its original cost to the lessor, or (2) the property can be used only by the lessee (referred to as "limited use property"), is not taken into account in determining whether the agreement is a lease.

A qualified agreement under the finance lease rules must be a lease determined without taking into account the fact that it contains a 10-percent fixed price purchase option or that the property is limited use property. Thus, the transaction must have economic substance independent of tax benefits. The lessor must reasonably

expect to derive a profit independent of tax benefits. In addition, the transaction, without taking into account the fact the agreement contains a fixed price purchase option or that the property is limited use property, must not otherwise be considered a financing arrangement or conditional sale.

The finance lease rules were to have been generally effective for agreements entered into after December 31, 1983, with three temporary restrictions intended to limit the tax benefits of finance leasing in 1984 and 1985. First, no more than 40 percent of property placed in service by a lessee during any calendar year beginning before 1986 was to qualify for finance lease treatment. Second, a lessor could not have used finance lease rules to reduce its tax liability for any taxable year by more than 50 percent. This 50-percent lessor cap was to apply to property placed in service on or before September 30, 1985. Third, the investment tax credit for property subject to a finance lease and placed in service on or before September 30, 1985, was only allowable ratably over 5 years, rather than entirely in the year the property is placed in service.

Notwithstanding these general rules, finance leasing was to be available for up to $150,000 per calendar year of a lessee's farm property for agreements entered into after July 1, 1982, and before 1984. Furthermore, the 40-percent lessee cap, 50-percent lessor cap, and 5-year spread of the investment credit did not apply to this amount of farm property.

The Tax Reform Act of 1984, however, postponed the effective date of the finance lease rules to generally apply to agreements entered into after December 31, 1987, and extended the three restrictions. Thus, the 40-percent lessee cap was extended to property placed in service by a lessee during any calendar year beginning before 1990; the 50-percent lessor cap was extended through September 30, 1989; and the 5-year spread of the investment credit for property subject to a finance lease was extended to property placed in service on or before September 30, 1989.

The Tax Reform Act of 1984 provided transitional rules which exempted property from the 4-year postponement if, before March 7, 1984, (1) a binding contract to acquire or construct the property was entered into by or for the lessee, (2) the property was acquired by the lessee, or (3) construction of the property was begun by or for the lessee. In addition, the Act exempted from the 4-year postponement property which is placed in service before 1988 and is (1) a qualified lessee's automotive manufacturing property (limited to an aggregate of $150 million of cost basis per lessee) or (2) property that was part of a coal-fired cogeneration facility for which certification and construction permit applications were filed on specified dates. The special rules relating to the availability of finance leasing for up to $150,000 per calendar year of a lessee's farm property were extended to cover agreements entered into before 1988.

Reasons for Change

The committee appreciates the simplicity of the present law Accelerated Cost Recovery System (ACRS), which provides a small number of depreciation classes and relatively short recovery periods. The committee chose to maintain this structure, while adopt-

ing improvements. For example, the committee believes ACRS can be made more neutral by increasing the recovery period for very long-lived equipment from 5 years to 10 years, and by extending the recovery period of real property. Another modification approved by the committee is to give equal recovery periods for the long-lived assets of regulated and nonregulated utilities. Under present law, nonregulated utilities receive more favorable depreciation treatment, which can give them an unfair competitive advantage where they provide essentially the same services as regulated utilities.

The committee believes some further acceleration in the rate of recovery of depreciation deductions should be provided to compensate partly for the repeal of the investment tax credit. The committee is cognizant that other nations heavily subsidize business investments through tax and other policies, and the committee does not believe such policies can be completely ignored. Therefore, it was the committee's judgment that to maintain the international competitiveness of U.S. business changes were necessary to the accelerated cost recovery system which, in certain cases, provided greater incentives than those existing under present law. The bill increases the rate of acceleration from 150-percent declining balance to 200-percent declining balance for property in the 5-year and 10-year classes. Together with the large tax rate reductions, investment incentives will remain high and the nation's savings can be utilized more efficiently.

The committee believes an efficient capital cost recovery system is essential to maintaining U.S. economic growth. As the world economies become increasingly competitive, it is most important that investment in our capital stock be determined by market forces rather than by tax considerations.

Under present law, the tax benefits arising from the combination of the investment tax credit and accelerated depreciation are more generous for some equipment than if the full cost of the investment were deducted immediately—a result more generous than exempting all earnings on the investment from taxation. At the same time, assets not qualifying for the investment credit and accelerated depreciation bear much higher effective tax rates. The output attainable from our capital resources is reduced because too much investment occurs in tax-favored sectors and too little investment occurs in sectors that are more productive, but which are tax-disadvantaged. The nation's output can be increased simply by a reallocation of investment, without requiring additional saving.

The committee believes the surest way of encouraging the efficient allocation of all resources and the greatest possible economic growth is by reducing statutory tax rates. A large reduction in the top corporate tax rate can be achieved by repealing the investment tax credit without reducing the corporate tax revenues collected. One distorting tax provision is replaced by lower tax rates which provide benefits to all investment. A neutral tax system allows the economy to most quickly adapt to changing economic needs.

Explanation of Provisions

1. Depreciation

a. Overview

The bill modifies the Accelerated Cost Recovery System by (1) prescribing depreciation methods for each ACRS class (in lieu of providing statutory tables), (2) reclassifying certain assets, including the creation of a second three-year class to which the straight-line method of depreciation applies, (3) providing more accelerated depreciation for the five- and ten-year ACRS classes (as revised by the bill), and (4) requiring the cost of real property to be recovered using the straight-line method over extended recovery periods. The bill also provides new averaging conventions for use in determining when property is treated as placed in service or disposed of during a taxable year.

The bill includes a provision for limited expensing of eligible property. In addition, the bill provides an alternative depreciation system based on ADR midpoints for (1) assets used abroad, (2) assets used by nontaxable entities, (3) computing earnings and profits of a corporation, (4) assets financed with the proceeds of tax-exempt obligations, and (5) computing the alternative minimum tax applicable to corporations and individuals. The bill also includes a new normalization requirement for assets used by public utilities.

Under the bill, if a lessee makes improvements to leased property, the cost of the leasehold improvement is recovered under the same rules that apply to an owner of property.

b. General rules

The bill reclassifies certain assets based on midpoint lives under the ADR system, as in effect on January 1, 1986 (Rev. Proc. 83–35, 1983–1 C.B. 745). Under the bill, eligible personal property is assigned among a three-year class, a five-year class, a ten-year class, or a fifteen-year class. The bill applies the 150-percent declining balance method, switching to the straight-line method at a time to maximize the recovery allowance, to certain property in the three-year class and to the fifteen year class. The depreciation method for other property in the three-year class is the straight-line method. The depreciation method applicable to property included in the five- and ten-year classes is the double declining balance method, switching to the straight-line method at a time to maximize the depreciation allowance. The cost of real property is recovered using the straight-line method. As under present law, the salvage value of property is treated as zero; thus, the entire cost or other basis of eligible property is recovered under the bill.

Eligible property

Under the bill, property eligible for the modified ACRS generally includes tangible depreciable property (both real and personal), whether new or used, placed in service after December 31, 1986. Eligible property does not include (1) property that the taxpayer properly elects to depreciate under the unit-of-production method or any other method not expressed in terms of years (other than

the "retirement replacement betterment" method or similar method), (2) any property used by a public utility (within the meaning of section 167(l)(3)(A)) if the taxpayer does not use a normalization method of accounting, (3) any motion picture film or video tape, (4) any sound recording described in section 280(c)(2), or (5) any property subject to ACRS as in effect before enactment of the bill or pre-ACRS depreciation rules (by application of an effective date or transitional rule). As under present law, intangible property may be amortizable under section 167.

Normalization requirements for public utility property

The bill continues the rule that public utility property is eligible for ACRS only if the tax benefits of ACRS are normalized in setting rates charged by utilities to customers and in reflecting operating results in regulated books of account. In addition to requiring the normalization of ACRS deductions, the bill provides for the normalization of excess deferred tax reserves resulting from the reduction of corporate income tax rates (with respect to prior depreciation or recovery allowances taken on assets placed in service before 1987). The bill provides that if an excess deferred tax reserve is reduced more rapidly or to a greater extent than such reserve would be reduced under the average rate assumption method, the taxpayer is not considered to be using a normalization method of accounting with respect to any of its assets. Thus, if the excess deferred tax reserve is not normalized, the taxpayer must compute its depreciation allowances using the depreciation method, useful life determination, averaging convention, and salvage value limitation used for purposes of setting rates and reflecting operating results in regulated books of account.

The bill provides that the excess deferred tax reserve is the reserve for deferred taxes computed under prior law over what the reserve for deferred taxes would be if the tax rate in effect under the bill had been in effect for all prior periods. The average rate assumption method is the method which reduces the excess deferred tax reserve over the remaining regulatory lives of the property which gave rise to the reserve for deferred taxes. Under this method, the excess deferred tax reserve is reduced as the timing differences (i.e., differences between tax depreciation and regulatory depreciation with respect to each asset or group of assets in the case of vintage accounts) reverse over the life of the asset. The reversal of timing differences generally occurs when the amount of the tax depreciation taken with respect to an asset is less than the amount of the regulatory depreciation taken with respect to the asset. Under the bill, the excess deferred tax reserve is multiplied by a formula that is designed to help insure that the excess is reduced to zero at the end of the regulatory life of the asset that generated the reserve.

The committee does not intend that the provisions apply retroactively to the excess deferred tax reserve generated from previous reductions in corporate tax rates. The committee intends that such previous excess deferred tax reserves will continue to be treated under prior law.

Classification of assets and recovery periods

Personal property

Three-year class.—The bill retains the three-year class for property with an ADR midpoint of four years or less, but excludes automobiles, light general purpose trucks, and over-the-road tractor units. In addition, property used in connection with research and experimentation is excluded from this three-year class if placed in service before January 1, 1990. Property used in connection with research and experimentation and excluded from the three-year class is included in the five-year class described below.

The cost of property in the three-year class is recovered using the 150-percent declining balance method, switching to the straight-line method at a time to maximize the deduction, and a three-year recovery period.

Straight-line three-year class.—The bill creates a second three-year class that includes automobiles, light general purpose trucks, and property used to manufacture semiconductors (described in ADR class 36.0).

The cost of property included in this three-year class is recovered using the straight-line method and a three-year recovery period.

Five-year class.—The bill modifies the five-year class by excluding property with ADR midpoint lives of 16 years or more, other than computer-based telephone central office switching equipment, and including research and experimentation property placed in service before January 1, 1990 and over-the-road tractor units. Telephone central office switching equipment is computer-based only if its functions are those of a computer (as defined in section 168(j)(4)(B)) in its capacity as telephone central office switching equipment. The identical qualities of this computer-based equipment and computers are the committee's basis for placing the computer-based equipment in the five-year class along with computers (rather than excluding such property because of its 18-year ADR midpoint life).

The cost of property included in the five-year class is recovered using the double declining balance method, switching to the straight-line method at a time to maximize the deduction, and a five-year recovery period.

Ten-year class.—The bill modifies the ten-year class by excluding public utility property with an ADR midpoint of 20 years or more, and including property that is excluded from the five-year class because it has an ADR midpoint of 16 years or more.

The cost of property included in the ten-year class is recovered using the double declining balance method, switching to the straight-line method at a time to maximize the deduction, and a ten-year recovery period.

15-year utility class.—Under the bill, the 15-year utility class includes all utility property—whether the property is used by a public utility or an unregulated company—with ADR midpoints of 20 years or more and steam and electric generation or distribution equipment described in ADR class 00.4.

Utility property is defined as any property used predominantly in the trade or business of furnishing or selling: (1) electrical energy, water, or sewage disposal services, (2) gas or steam through

a local distribution system, (3) telephone services, (4) other communication services if furnished or sold by the Communications Satellite Corporation for purposes authorized by the Communications Satellite Act, or (5) transportation of gas or steam by pipeline. The determination of whether property constitutes utility property is made without regard to whether rates are established or approved by a regulatory body.

Real property

The bill provides different recovery periods for residential rental property and nonresidential real property.

Residential rental property.—The bill defines residential rental property as a building or structure with respect to which 80 percent or more of the gross rental income is rental income from dwelling units. The term "dwelling unit" is defined as a house or apartment used to provide living accommodations, but does not include a unit in a hotel, motel, inn, or other establishment more than one-half of the units in which are used on a transient basis. If any portion of a building or structure is occupied by the taxpayer, the gross rental income from such property shall include the rental value of the portion so occupied.

The cost of residential rental property is recovered using the straight-line method of depreciation, and a recovery period of 27.5 years.

Nonresidential real property.—The bill defines nonresidential real property to include section 1250 class property that has a class life of more than 12.5 years and is not residential real property.

The cost of nonresidential real property is recovered using the straight-line method of depreciation, and a recovery period of 31.5 years.

Optional depreciation method

The bill repeals the provision that permits taxpayers to elect use of the straight-line method over an optional recovery period. The election to use the straight-line method over the applicable ACRS recovery period is retained. Further, a taxpayer is permitted to elect use of an alternative depreciation system based on ADR midpoints (described below) for property that is otherwise eligible for ACRS.

Changes in classifications

The Secretary, through an office established in the Treasury Department (including the Internal Revenue Service), is authorized to monitor and analyze actual experience with all tangible depreciable assets, to prescribe a new class life for any property or class of property (other than property that is specifically assigned to an ACRS class under the bill notwithstanding its existing ADR midpoint) when appropriate, and to prescribe a class life for any property that does not have a class life. If the Secretary prescribes a new class life for property (other than real property or other property that is specifically assigned), such life will be used in determining the classification of the property. The prescription of a new class life for property will not change the ACRS class structure, but will affect the ACRS class in which the property falls.

Any class life prescribed under the Secretary's authority must reflect the anticipated useful life, and the anticipated decline in value over time, of an asset to the industry or other group. Thus, useful life means the economic life span of property over all users combined and not, as under prior law, the typical period over which a taxpayer holds the property. Evidence indicative of the useful life of property which the committee intends the Secretary will take into account in prescribing a class life includes the depreciation practices followed by taxpayers for book purposes with respect to the property. It also includes useful lives experienced by taxpayers, according to their reports. It further includes independent evidence of minimal useful life—the terms for which new property is leased, used under a service contract, or financed—and independent evidence afforded by resale price data.

The committee expects that initial studies will concentrate on property that now has no ADR midpoint.

Averaging conventions

The following averaging conventions apply to depreciation computations made under both ACRS (as modified by the bill) and the alternative depreciation system (described below) provided by the bill. The recovery period begins on the date property is placed in service under the applicable convention.

Half-year convention

In general, a half-year convention applies under which all property placed in service or disposed of during a taxable year is treated as placed in service or disposed of at the midpoint of such year. As a result, a half-year of depreciation is allowed for the first year property is placed in service, regardless of when the property is placed in service during the year, and a half-year of depreciation is allowed for the year in which property is disposed of or is otherwise retired from service.

To illustrate the half-year convention, assume that a taxpayer places in service a $100 asset that is assigned to the five-year class. ACRS deductions, beginning with the first taxable year and ending with the sixth year, are $20, $32, $19.20, $11.52, $11.52, and $5.76. If the asset were disposed of in year two, the ACRS deduction for that year would be $16.

Mid-month convention

In the case of both residential rental property and nonresidential real property, a mid-month convention applies. Under the mid-month convention, the depreciation allowance for the first year property is placed in service is based on the number of months the property was in service, and property placed in service at any time during a month is treated as having been placed in service in the middle of the month. Further, property disposed of by a taxpayer at any time during a month is treated as having been disposed of in the middle of the month.

Special rule where substantial property placed in service during last three months of year

Except as provided in regulations, the mid-month convention applies to all property a taxpayer places in service during a taxable year if more than 40 percent of the aggregate bases of that property is placed in service during the last three months of the taxable year. For purposes of applying the 40-percent test, residential rental property and nonresidential real property are not taken into account.

Short taxable years

As under present law, in the case of a taxable year that is less than 12 months, the amount of the ACRS deduction allowed is an amount that bears the same relationship to the deduction allowable otherwise as the number of months in the short taxable year bears to 12. This rule does not apply to residential rental property or nonresidential real property.

c. Alternative depreciation system

In general

In general, ACRS deductions are reduced for property that (1) is used predominantly outside the United States ("foreign-use" property), (2) is leased to or otherwise used by a tax-exempt entity, including a foreign person unless more than 50 percent of the gross income derived from the property by such person is subject to U.S. tax ("tax-exempt use" property), (3) is financed directly or indirectly by an obligation, the interest on which is exempt from taxation under section 103(a) ("tax-exempt bond financed" property), (4) is imported from a foreign country with respect to which an Executive Order is in effect because the country maintains trade restrictions or engages in other discriminatory acts, or (5) with respect to which an election to decelerate depreciation deductions is made. In these cases, depreciation allowances are computed under the alternative depreciation system, which provides for straight-line recovery (without regard to salvage value) and use of the applicable averaging conventions described above.

The recovery period under the alternative system generally is equal to the property's ADR midpoint life (12 years for personal property with no ADR midpoint life, and 40 years for real property). Qualified technological equipment (as defined under the rules for tax-exempt use property), automobiles, light purpose trucks, and over-the-road tractor units are treated as having a recovery period of five years.

The alternative depreciation system is used for purposes of computing the earnings and profits of a foreign or domestic corporation, as well as for purposes of computing the portion of depreciation allowances treated as an item of tax preference under the alternative minimum tax applicable to corporations and individuals. The bill also modifies the treatment of depreciation deductions for luxury automobiles and mixed-use property.

Foreign-use property

As under present law, foreign-use property is property that is used outside the United States more than half of a taxable year. In addition to the exceptions to this general rule that are applicable under present law, the bill provides a new exception for any satellite or other space craft (or any interest therein) held by a U.S. person if such property is launched from within the United States.

Tax-exempt use property

The bill retains the rules for tax-exempt use property, including the rules that (1) increase the recovery period used for purposes of computing depreciation to a period not less than 125 percent of the lease term, if this period would be longer than the depreciation period otherwise applicable to the property, and (2) treats qualified technological equipment with a lease term that exceeds five years as having a recovery period of five years.

Tax-exempt bond financed property

The bill modifies the definition of tax-exempt bond financed property to include any property if part or all of such property is financed (directly or indirectly) by an obligation the interest on which is exempt from tax under section 103(a). For purposes of this rule, the proceeds of an obligation are treated as used to finance property acquired in connection with the issuance of an obligation in the order in which such property was acquired. Solely for purposes of applying the alternative depreciation system to tax-exempt bond financed property, (1) solid waste disposal facilities and hazardous waste facilities are treated as having an ADR midpoint of eight years, and (2) low-income residential rental property is treated as having a recovery period of 27.5 years.

Luxury automobiles and mixed-used property

The bill conforms the fixed limitations applicable to automobiles so that the price range of affected cars is unchanged. Under the bill, depreciation deductions are limited to $2,133 for the first year in the recovery period, and $4,210 for each succeeding year. In addition, the bill clarifies that the fixed limitations apply to all deductions claimed for depreciation of automobiles, not just ACRS deductions.

For mixed-use property that is used 50 percent or more for personal purposes, depreciation deductions are computed under the alternative depreciation system.

Certain imported property

The bill authorizes the President to provide by Executive Order for the application of the alternative depreciation system to certain property that is imported from a country maintaining trade restrictions or engaging in discriminatory acts. For purposes of this provision, the term imported property means any property that is completed outside the United States, or less than 50 percent of the basis of which is attributable to value added within the United States. In applying this test, the term "United States" is treated as

including the Commonwealth of Puerto Rico and the possessions of the United States.

The bill authorizes reduced depreciation for property that is imported from a foreign country that (1) maintains nontariff trade restrictions that substantially burden U.S. commerce in a manner inconsistent with provisions of trade agreements, including variable import fees, or (2) engages in discriminatory or other acts or policies unjustifiably restricting U.S. commerce (including tolerance of international cartels). If the President determines that a country is engaging in the proscribed actions noted above, he may provide for the application of alternative depreciation to any article or class of articles manufactured or produced in such foreign country for such period as may be provided by Executive Order.

In general, the terms of the provision relating to certain imported property are substantially identical to those of section 48(a)(7) relating to the investment tax credit (which is repealed by sec. 211 of the bill).

Election to use alternative depreciation system

A taxpayer may irrevocably elect to apply the alternative system to any class of property for any taxable year. If the election is made, the alternative system applies to all property in the ACRS class placed in service during the taxable year. For residential rental property and nonresidential real property, this election may be made on a property-by-property basis. The election to use the alternative system is in addition to the election to recover costs using the straight-line method over the ACRS recovery period (described above).

d. Mass asset vintage accounts

The bill continues the Secretary's regulatory authority to permit a taxpayer to maintain one or more mass asset accounts for any property in the same ACRS class and placed in service in the same year. As under present law, unless otherwise provided in regulations, the full amount of the proceeds realized on disposition of property from a mass asset account are to be treated as ordinary income (without reduction for the basis of the asset). As a corollary, no reduction is to be made in the depreciable basis remaining in the account. The limitations on the ability to establish mass asset accounts under present law, as proposed in Treasury regulations, resulted, in part, from a concern about the mechanics of recapturing investment tax credits on dispositions of property from an account. To facilitate the application of the recapture rules without requiring that individual assets be identified, the proposed regulations provide mortality dispersion tables that cannot be applied easily to diverse assets. In view of the provision of the bill that repeals the investment tax credit, the primary reason for restricting a taxpayer's ability to establish vintage accounts would be set aside. Accordingly, the committee expects that the definition of assets eligible for inclusion in mass asset accounts will be expanded to include diverse assets.

e. Lessee leasehold improvements

The cost of leasehold improvements made by a lessee is to be recovered under the rules applicable to other taxpayers, without regard to the lease term. On termination of the lease, the lessee who does not retain the improvements is to compute gain or loss by reference to the adjusted basis of the improvement at that time.

In light of the bill's treatment of a lessee's capital costs, the only future relevance of section 178 will be in determining the amortization period for lease acquisition costs. Accordingly, the bill makes conforming changes to section 178. Under section 178 as revised by the bill, the term of a lease is determined by including all renewal options as well as any other period for which the parties reasonably expect the lease to be renewed.

f. Treatment of certain transferees

A special rule applies after the transfer of any property in a nonrecognition transaction described in section 332, 351, 361, 371(a), 374(a), 721, or 731 (other than the case of a termination of a partnership under 708(b)(1)(B)). In any such case, the transferee is treated as the transferor for purposes of computing the depreciation deduction with respect to so much of the basis in the hands of the transferee as does not exceed the adjusted basis in the hands of the transferor. Thus, the transferee of property in one of the transactions described above "steps into the shoes" of the transferor to the extent the property's basis is not increased as the result of the transaction. To the extent the transferee's basis exceeds the property's basis in the hands of the transferor (e.g., because the transferor recognized gain in the transaction), the transferee depreciates the excess under the bill's general rules.

g. Additions or improvements to property

The bill preserves the prohibition against use of the component method of depreciation. The bill provides that the recovery period for any addition or improvement to real or personal property begins on the later of (1) the date on which the addition or improvement is placed in service, or (2) the date on which the property with respect to which such addition or improvement is made is placed in service. Any ACRS deduction for an addition or improvement to a property is to be computed in the same manner as the deduction for the underlying property would be if such property were placed in service at the same time as such addition or improvement. Thus, for example, the cost of a post-effective date improvement to a building that constitutes nonresidential real property is recovered over 31.5 years using the straight-line method (i.e., the same recovery period and method that would apply to the building if it were placed in service after the effective date, unless a transitional rule applies to such improvement).

h. Expensing in lieu of cost recovery

The bill continues the provision under which a taxpayer (other than a trust or estate) can elect to treat the cost of qualifying property as an expense that is not chargeable to capital account, with four modifications. The costs for which the election is made are al-

lowed as a deduction for the taxable year in which the qualifying property is placed in service.

Under the first modification, the dollar limitation on the amount that can be expensed is $10,000 a year ($5,000 in the case of a married individual filing a separate return).

The second modification provides that the election to expense qualifying property is unavailable to any taxpayer for any taxable year in which the aggregate cost of qualifying property placed in service during such taxable year exceeds $200,000. For every dollar of investment in excess of $200,000, the $10,000 ceiling is reduced by $1.

The third modification limits the amount eligible to be expensed to the taxable income derived from the active trade or business in which the related property is used. For purposes of this rule, taxable income from the conduct of an active trade or business is computed separately with respect to each trade or business, and without regard to the cost of the expensed property. For purposes of this rule, the Secretary is authorized to prescribe regulations for the allocation of items of income or expense to a trade or business.

Costs that are disallowed as a result of the limitation based on taxable income are carried forward to the succeeding taxable year (and added to the amount eligible to be expensed under this provision for that year).

Under the fourth modification, if property is converted to nonbusiness use at any time, the difference between the amount expensed and the ACRS deductions that would have been allowed for the period of business use is recaptured as ordinary income.

i. Disposition of assets and recapture

As under present law, if a taxpayer uses ACRS to recover the costs of tangible property (other than residential rental property and nonresidential real property), all gain on the disposition of such property is recaptured as ordinary income to the extent of previously allowed depreciation deductions. For purposes of this rule, any deduction allowed under section 179 (relating to the expensing of up to $10,000 of the cost of qualifying property), 190 (relating to the expensing of the costs of removing certain architectural and transportation barriers), or 193 (relating to tertiary injectant expenses) is treated as a depreciation deduction.

There is no recapture of previously allowed depreciation deductions in the case of residential rental property and nonresidential real property.

2. Regular Investment Tax Credit

The bill repeals the regular investment tax credit.

3. Finance Leases

The bill repeals the finance leasing rules.

Effective Dates

In general

In general, the provisions that modify ACRS apply to all property placed in service after December 31, 1986. The provision that repeals the regular investment tax credit is effective for property placed in service after December 31, 1985. Repeal of the finance lease rule is effective for agreements entered into after December 31, 1986.

Transitional rules

Overview

The bill provides certain exceptions to the general effective dates, in the case of property constructed, reconstructed, or acquired pursuant to a written contract that was binding as of March 1, 1986, (December 31, 1985, for purposes of the investment tax credit) or in other transitional situations discussed below. Except in the case of qualified solid waste disposal facilities and certain satellites (described below), the application of the bill's transitional rules is conditioned on property being placed in service by a prescribed date in the future. In addition, special rules are provided for investment credits claimed on transitional property, tax-exempt bond financed property, and the finance lease rules.

Except as otherwise provided, for purposes of the depreciation transitional rules, rules described below do not apply to any property unless the property has an ADR midpoint of seven years or more and is placed in service before the applicable date, determined according to the following: (1) for property with an ADR midpoint less than 20 years (other than computer-based telephone central office switching equipment), January 1, 1989, and (2) for property with an ADR midpoint of 20 years or more, residential rental property, and nonresidential real property, January 1, 1991.

For purposes of the investment tax credit transitional rules, the applicable placed-in-service dates are: (1) for property with an ADR midpoint less than five years, July 1, 1986, (2) for property with an ADR midpoint of at least five but less than seven years and including computer-based telephone central office switching equipment, January 1, 1987, (3) for property with an ADR midpoint of at least seven but less than 20 years (other than computer-based telephone central office switching equipment), January 1, 1989, and (4) for property with an ADR midpoint of 20 years or more, residential rental property, and nonresidential real property, January 1, 1991.

For purposes of the general effective dates, if at least 80 percent of a target corporation's stock is acquired on or before December 31, 1986, (December 31, 1985, for purposes of the investment tax credit) and the acquiring corporation makes a section 338 election to treat the stock purchase as an asset purchase after the relevant date, then the deemed new target corporation is treated as having purchased the assets before the general effective date.

Anti-churning rules

The bill expands the scope of the present law anti-churning rules to prevent taxpayers from bringing certain property placed in serv-

ice before January 1, 1987 under the modified ACRS. The expanded anti-churning rules apply to all ACRS property other than residential rental property and nonresidential real property. The bill retains the anti-churning rules applicable to property that was originally placed in service before January 1, 1981. The committee intends that the anti-churning rules will not apply in the case of property placed in service before January 1, 1987 for personal use and converted to business use after January 1, 1987; such property is treated as originally placed in service when it is first placed in service for business use.

Binding contracts

The bill does not apply to property that is constructed, reconstructed, or acquired by a taxpayer pursuant to a written contract that was binding as of March 1, 1986 (December 31, 1985, for investment tax credits), and at all times thereafter. If a taxpayer transfers his rights in any such property under construction or such contract to another taxpayer, the bill does not apply to the property in the hands of the transferee, as long as the property was not placed in service before the transfer by the transferor. For purposes of this rule, if by reason of sales or exchanges of interests in a partnership, there is a deemed termination and reconstitution of a partnership under section 708(b)(1)(B), the partnership is to be treated as having transferred its rights in the property under construction or the contract to the new partnership.

The general binding contract rule applies only to contracts in which the construction, reconstruction, erection, or acquisition of property is itself the subject matter of the contract.

A contract is binding only if it is enforceable under State law against the taxpayer, and does not limit damages to a specified amount (e.g., by use of a liquidated damages provisions). A contractual provision that limits damages to an amount equal to at least five percent of the total contract price is not treated as limiting damages.

For purposes of the general binding contract rule, a contract under which the taxpayer is granted an option to acquire property is not to be treated as a binding contract to acquire the underlying property. In contrast, a contract under which the taxpayer grants an irrevocable put (i.e., an option to sell) to another taxpayer is treated as a binding contract, as the grantor of such an option does not have the ability to unilaterally rescind the commitment. In general, a contract is binding even if subject to a condition, as long as the condition is not within the control of either party or a predecessor (except in the limited circumstances described below). A contract that was binding as of March 1, 1986 (or December 31, 1985, in the case of the investment tax credit) will not be considered binding at all times thereafter if it is substantially modified after that date.

A binding contract to acquire a component part of a larger property will not be treated as a binding contract to acquire the larger property under the general rule for binding contracts. For example, if a written binding contract to acquire an aircraft engine was entered into before March 2, 1986, there would be a binding contract to acquire only the engine, not the entire aircraft.

Self-constructed property

The bill does not apply to property that is constructed or reconstructed by the taxpayer, if (1) the lesser of $1 million or five percent of the cost of the property was incurred or committed, (i.e., required to be incurred pursuant to a written binding contract in effect) as of March 1, 1986 (December 31, 1985, for purposes of the investment tax credit) and (2) the construction or reconstruction began by that date. For purposes of this rule, a taxpayer who serves as the engineer and general contractor of a project is to be treated as constructing the property. For purposes of this rule, the construction of property is considered to begin when physical work of a significant nature starts. Construction of a facility or equipment is not considered as begun if work has started on minor parts or components. Physical work does not include preliminary activities such as planning or designing, securing financing, exploring, researching, or developing.

Equipped buildings

Under the bill, where construction of an equipped building began on or before March 1, 1986 (December 31, 1985, for purposes of the investment tax credit), pursuant to a written specific plan, and more than one-half the cost of the equipped building (including any machinery and equipment for it) was incurred or committed before March 2, 1986 (January 1, 1986, for the investment tax credit) the entire equipped building project and incidental appurtenances are excepted from the bill's application. Where the costs incurred or committed before March 2, 1986 (January 1, 1986, for the investment tax credit) do not equal more than half the cost of the equipped building, each item of machinery and equipment is treated separately for purposes of determining whether the item qualifies for transitional relief.

Under the equipped building rule, the bill will not apply to equipment and machinery to be used in the completed building, and also incidental machinery, equipment, and structures adjacent to the building (referred to here as appurtenances) which are necessary to the planned use of the building, where the following conditions are met:

(1) The construction (or reconstruction or erection) or acquisition of the building, machinery, and equipment was pursuant to a specific written plan of a taxpayer in existence on March 1, 1986 (December 31, 1985, for the investment tax credit); and

(2) More than 50 percent of the adjusted basis of the building and the equipment and machinery to be used in it (as contemplated by the written plan) was attributable to property the cost of which was incurred or committed by March 1, 1986 (December 31, 1985, for the investment tax credit), and construction commenced on or before March 1, 1986 (December 31, 1985, for the investment tax credit).

The written plan for an equipped building may be modified to a minor extent after March 1, 1986 (December 31, 1985, for the investment tax credit) (and the property involved still come under this rule); however, there cannot be substantial modification in the plan if the equipped building rule is to apply. The plan referred to

must be a definite and specific plan of the taxpayer that is available in written form as evidence of the taxpayer's intentions.

The equipped building rule can be illustrated by an example where the taxpayer has a plan providing for the construction of a $100,000 building with $80,000 of machinery and equipment to be placed in the building and used for a specified manufacturing process. In addition, there may be other structures or equipment, here called appurtenances, which are incidental to the operations carried on in the building, that are not themselves located in the building. Assume that the incidental appurtenances have further costs of $30,000. These appurtenances might include, for example, an adjacent railroad siding, a dynamo or water tower used in connection with the manufacturing process, or other incidental structures or machinery and equipment necessary to the planned use of the building. Of course, appurtenances, as used here, do not include a plant needed to supply materials to be processed or used in the building under construction. In this case, if the building qualified as transition property but no equipment had been ordered, and the appurtenances had not been constructed or placed under binding order, the equipped building rule would apply. This is true because the building cost represents more than 50 percent of the total $180,000. As a result, the machinery and equipment, even though not under binding contract, is eligible for the rule. In this connection, it should be noted that the additional cost of appurtenances, $30,000, is not taken into account for purposes of determining whether the 50-percent test is met. Nevertheless, the bill would not apply to these appurtenances since the 50-percent test is met as to the equipped building.

Plant facilities

The bill also provides a plant facility rule that is comparable to the equipped building rule (described above), for cases where the facility is not housed in a building. For purposes of this rule, the term "plant facility" means a facility that does not include any building (or of which buildings constitute an insignificant portion), and that is a self-contained single operating unit or processing operation—located on a single site—identifiable as a single unitary project as of March 1, 1986.

If pursuant to a written specific plan of a taxpayer in existence as of March 1, 1986 (December 31, 1985, for the investment tax credit), the taxpayer constructed, reconstructed, or erected a plant facility, the construction, reconstruction, or erection commenced as of March 1, 1986 (December 31, 1985, for the investment tax credit), and the 50-percent test is met, then the bill will not apply to property that makes up the facility. For this purpose, construction, etc., of a plant facility is not considered to have begun until it has commenced at the site of the plant facility. (This latter rule does not apply if the facility is not to be located on land and, therefore, where the initial work on the facility must begin elsewhere.) In this case, as in the case of the commencement of construction of a building, construction begins only when actual work at the site commences; for example, when work begins on the excavation for footings, etc., or pouring the pads for the facility, or the driving of foundation pilings into the ground. Preliminary work, such as

clearing a site, test drilling to determine soil condition, or excavation to change the contour of the land (as distinguished from excavation for footings), does not constitute the beginning of construction, reconstruction or erection.

Special rules for sale-leasebacks within 90 days

Property is treated as meeting the requirements of a transitional or general effective date rule if (1) the property is placed in service by a taxpayer who acquired the property from a person in whose hands the property would qualify under a transitional or general effective date rule, (2) the property is leased back by the taxpayer to such person, and (3) the leaseback occurs within 90 days after such property was originally placed in service, but no later than the applicable date. The committee intends that the special rule for sale-leasebacks apply to any property that qualifies for transitional relief under the bill or that was originally placed in service by the lessee under the sale-leaseback before the general effective date. This rule would apply where a taxpayer acquires property from a manufacturer, places the property in service by leasing it to the ultimate user, and subsequently engages in a sale-leaseback within 90 days after the property was originally placed in service under the initial lease.

Special rules for tax-exempt bond financed property

The provision restricting ACRS deductions for property financed with tax-exempt bonds applies to property placed in service after December 31, 1986, part or all of such property is financed (directly or indirectly) by the proceeds of bonds issued after March 1, 1986. The revised restrictions on ACRS deductions do not apply to facilities placed in service after December 31, 1986, if—

(1) the original use of the facilities commences with the taxpayer and the construction (including reconstruction or rehabilitation) commenced before March 2, 1986, and was completed after that date;

(2) a binding contract to incur significant expenditures for the construction (including reconstruction or rehabilitation) of the property financed with the bonds was entered into before March 2, 1986, was binding at all times thereafter, and some or all of the expenditures were incurred after March 1, 1986; or

(3) acquired after March 1, 1986, pursuant to a binding contract entered into before March 2, 1986, and that is binding at all times after March 1, 1986.

For purposes of this restriction, the determination of whether a binding contract to incur significant expenditures existed before March 2, 1986, is made in the same manner as under the rules governing the redefinition of industrial development bonds.

The restrictions on ACRS deductions for bond-financed property do not apply to property placed in service after December 31, 1986, to the extent that the property is financed with tax-exempt bonds issued before March 2, 1986. ACRS deductions for such property may be determined, however, under the rules generally provided by the bill. For purposes of this exception, a refunding issue issued after March 1, 1986, generally is treated as a new issue and the taxpayer must use the alternative depreciation method provided by

the bill for costs that are unrecovered on the date of the refunding issue.

In cases where a change of recovery method is required because of a refunding issue, only the remaining unrecovered cost of the property is required to be recovered using the alternative depreciation system provided by the bill. Therefore, no retroactive adjustments to ACRS deductions previously claimed are required when a pre-March 2, 1986, bond issue is refunded where no significant expenditures are made with respect to the facility after December 31, 1986.

Contract with persons other than a person who will construct or supply the property

The bill provides transitional relief for certain situations where written binding contracts require the construction or acquisition of property, but the contract is not between the person who will own the property and the person who will construct or supply the property. This rule applies to written service or supply contracts and agreements to lease entered into before March 2, 1986 (January 1, 1986, in the case of the investment tax credit). An example of a case to which this rule would apply would be lease agreements under which a grantor trust is obligated to provide property under a finance lease (to the extent continued under the bill).

This transitional rule is applicable only where the specifications and amount of the property are readily ascertainable from the terms of the contract, or from related documents. A supply or service contract or agreement to lease must satisfy the requirements of a binding contract (discussed above). This rule does not provide transitional relief to property in addition to that covered under a contract described above, which additional property is included in the same project but does not otherwise qualify for transitional relief.

Development agreements relating to large-scale multi-use urban projects

The bill does not apply to property that is included in a "qualified urban renovation project." The term qualified urban renovation project includes certain projects that satisfy the following requirements as of March 1, 1986 (December 31, 1985, for the investment tax credit): the project is described in the bill and (1) was publicly announced by a political subdivision, for the renovation of an urban area in its jurisdiction, (2) was either the subject of an agreement for development or a lease between such political subdivision and the primary developer of the project, or was undertaken pursuant to the political subdivision's grant of development rights to a primary developer-purchaser; or (3) was identified as a single unitary project in the internal financing plans of the primary developer, and (4) is not substantially modified at any time after March 1, 1986 (December 31, 1985, for the investment tax credit).

Federal Energy Regulatory Commission application or action

The requirements of the general binding contract rule will be treated as satisfied with respect to a project if, on or before March 1, 1986, (December 31, 1985, for the investment tax credit), the Fed-

eral Energy Regulatory Commission ("FERC") licensed the project or certified the project as a "qualifying facility" for purposes of the Public Utility Regulatory Policies Act of 1978 ("PURPA"). A project that a developer has simply put FERC on notice is a qualifying facility is not *certified* as a qualifying facility.

This rule will not apply if a FERC license or certification is substantially amended after March 1, 1986 (December 31, 1985, for the investment tax credit). On the other hand, minor modifications will not affect the application of this rule (e.g., technical changes in the description of a project, extension of the deadline for placing property in operation, changes in equipment or in the configuration of equipment).

The committee is informed that FERC does not distinguish between an application to amend an existing certificate and one to have a project recertified and responds in both cases by "recertifying" the project. The committee intends that substance should control over form, and property will remain transitional property if no substantial change occurs. Similarly, a mere change in status from a "qualifying small power production facility" to a "qualifying cogeneration facility," under PURPA, without more, would not affect application of the transitional rule. The following paragraph provides guidance about how the "substance over form" rule applies in typical cases.

The requirements of the transitional rule for FERC Certification will not be violated under the following circumstances: (1) after FERC certification, the introduction of efficiencies results in a reduction of the project cost and an increase in net electricity output, and the FERC certificate is amended to reflect the higher electricity output, (2) a project was originally certified as three separate facilities, but the taxpayer determines that it is more efficient to have a single powerhouse, and the FERC certification is amended to have the facilities combined under a single certificate.

The bill also provides transitional relief for hydroelectric projects of less than 80 megawatts if an application for a license was filed with FERC before March 2, 1986.

Qualified solid waste disposal facilities

The bill does not apply to a qualified solid waste disposal facility if, before March 2, 1986 (for the investment tax credit, January 1, 1986), (1) there is a written binding contract between a service recipient and a service provider, providing for the operation of such facility and the payment for services to be provided by the facility, or (2) a service recipient, governmental unit, or any entity related to such an entity made a financial commitment of at least $200,000 to the financing or construction of the facility.

For purposes of this rule, a qualified solid waste disposal facility is a facility (including any portion of the facility used for power generation or resource recovery) that provides solid waste disposal services for residents of part or all of one or more governmental units, if substantially all of the solid waste processed at such facility is collected from the general public. This rule does not apply to replacement property. For example, assume a taxpayer/service provider enters into a long-term service contract before January 1, 1986, and a facility is initially placed in service after that date.

Assume that the taxpayer finds it necessary to replace the facility 20 years later, pursuant to its obligation to provide continuing services under the pre-1987 service contract. The special rule will apply only to the first facility necessary to fulfill the taxpayer's obligations under the service contract.

For purposes of this provision, a contract is to be considered as binding notwithstanding the fact that the obligations of the parties are conditioned on factors such as the receipt of permits, satisfactory construction or performance of the facility, or the availability of acceptable financing. A change in the method or amount of compensation for services under the contract will not be considered a substantial modification of the contract if, taken as a whole, the change does not materially affect the scope or function of the project.

A service recipient or governmental unit or a related party is to be treated as having made a substantial financial commitment to a facility if one or more entities have issued bonds or other obligations aggregating more than 10 percent of the anticipated capital cost of such facility, the proceeds of which are identified as being for such facility or for a group of facilities that include the facility, or if one or more entities have expended in the aggregate at least $200,000 of their funds, or utilized or committed at least $200,000 of their assets, toward the development or financing of such facility. If a governmental entity acquires a site for a facility by purchase, option to purchase,[1] purchase contract, condemnation, or entering into an exchange of land, it shall be considered to have made a financial commitment equal to the fair market value of such site for purposes of this rule. For purposes of this provision, entities are related if they are described in section 168(h)(4)(A)(i).

Other exceptions

The bill also provides other special transitional rules of limited application. The bill does not apply to (1) those mass commuting vehicles exempted from the application of the tax-exempt leasing rules under DEFRA, (2) a qualified lessee's automotive manufacturing property that was exempted from deferral of the finance lease rules, or (3) a qualified lessee's farm property that was exempted from deferral of the finance lease rules. Under the special rule for master plans for integrated projects, the committee intends that, (1) in the case of multi-step plans described in sec. 202(d)(5)(E) of the bill, the rule will include executive approval of a plan, if there has also been executive authorization of expenditures under the plan before September 26, 1985, and (2) in the case of single-step plans described in sec. 202(d)(5)(E) of the bill, the rule will include project-specific designs for which expenditures were incurred or committed before September 26, 1985.

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[1] In the case of an option to purchase, the committee intends the governmental entity to be treated as having made a financial commitment only if an amount is paid for the option and such consideration is forfeitable.

Special rules applicable to the regular investment credit

Reduction of ITC carryyforwards and credits claimed under transitional rules

If a regular investment tax credit is allowable for a taxable year beginning after December 31, 1986, the amount allowable is reduced by 30 percent (15 percent, in the case of credits allowable for a taxable year beginning in 1987). The amount by which the credit is reduced will not be allowed as a credit for any other taxable year. The one-time reduction in the amount of credits claimed under transitional rules and credit carryforwards is included because of the lower marginal tax rates under the bill. For purposes of determining the extent to which an investment credit determined under section 46 is used in a taxable year beginning after December 31, 1986, the order in which other credits included in a taxpayer's general business credit are used shall be determined on the basis of the order in which they are listed in section 38(b). This rule is inapplicable to credits that a steel company elects to carryback 15 years under the special rule described below.

The 30-percent reduction applies to credits claimed under transitional rules provided by the bill and credits that are carried forward from years prior to January 1, 1986. In the case of transitional property, the reduction applies to the full amount of credit allowable (determined without regard to an election to take a reduced credit in lieu of a half-basis adjustment). In the case of an election to take a reduced credit in lieu of a half-basis adjustment, the full percentage reduction applies to the reduced amount of the credit. The provision does not affect the requirement that a half-basis adjustment be computed by reference to the full amount of credit earned.

A taxpayer in whose hands property qualifies for transitional relief can make an election under section 48(d) to pass the credit claimed to a lessee.

Elective 15-year carryback for certain taxpayers

Certain companies can elect a 15-year carryback of 50 percent of investment tax credit carryforwards in existence as of the beginning of a taxpayer's first taxable year beginning after December 31, 1985. The amount carried back is treated as a payment against the tax imposed by chapter 1 of the Internal Revenue Code, made on the last day prescribed by law (without regard to extensions) for filing a return of tax under chapter 1 of the Code for the first taxable year beginning on or after January 1, 1986. The amount carried back would reduce tax liability for the first taxable year beginning after December 31, 1985; to the extent the amount carried back exceeds the tax liability for such year, any excess could be claimed as a refund under generally applicable rules. Carryforwards taken into account under the carryback rule are not taken into account under section 38 for any taxable year beginning after the termination date. Generally, taxpayers eligible to elect the 15-year carryback are domestic corporations engaged in the manufacture and production of steel.

The amount claimed as a payment against the tax for the first taxable year beginning on or after January 1, 1986 cannot exceed

the taxpayer's net tax liability. The net tax liability is the amount of tax liability for all taxable years during the carryback period (not including minimum tax liability), reduced by the sum of credits allowable (other than the credit under section 34 relating to certain fuel taxes). The carryback period is the period that (1) begins with the taxpayer's 15th taxable year preceding the first taxable year from which there is a credit included in the taxpayer's existing carryforward (in no event can such period begin before the first taxable year ending after December 31, 1961), and (2) ends with the corporation's last taxable year beginning before January 1, 1986.

For purposes of determining the net tax liability and the existing carryovers for a member of an affiliated group that files a consolidated return, the member will generally be treated as if it had filed separate returns for prior years. The member's allocable shares of consolidated net tax liability and existing carryovers for the prior years will be used to determine the amount of any refund or credit.

Normalization requirement for public utility property

The bill provides that if the tax benefits of previously allowed investment tax credits on public utility property are not normalized, then certain investment tax credits will be recaptured. In general, the amount recaptured is the greater of (1) all investment tax credits for open taxable years of the taxpayer or (2) unamortized credits of the taxpayer or credits not previously restored to rate base (whether or not for open years), whichever is applicable. If such credits have not been utilized and are being carried forward, the carryforward amount is reduced in lieu of recapture. These rules apply to violations of the relevant normalization requirements occurring in taxable years ending after December 31, 1985. Similar principles apply to the failure to normalize the tax benefits of previously allowed employee stock ownership plan credits.

General treatment of QPEs

Neither the repeal of the regular investment credit nor the 15- or 30-percent reduction of credits affects QPEs claimed with respect to the portion of the basis of any progress expenditure property attributable to progress expenditures for periods before January 1, 1986. After December 31, 1985, QPEs cannot be claimed unless it is reasonable to expect that the property will be placed in service before the applicable date. The determination of whether it is reasonable to expect that the placement-in-service requirement will be met is to be made on a year-by-year basis, beginning with the first taxable year that includes January 1, 1986. For any taxable year in which reasonable expectations change, no QPEs will be allowed, and previously claimed QPEs will be recaptured. Further, if the property is not placed in service on or before the last applicable date, post-1985 QPEs will be recaptured in the taxable year that includes such date.

Special rules for television and motion picture films

Special transitional rules apply to television and motion picture films for purposes of the investment credit (but not depreciation). For purposes of the general binding contract rule, (1) construction

is treated as including production, (2) in accordance with industry practice, written contemporaneous evidence of a binding contract is treated as a written binding contract, and (3) in the case of any television film, a license agreement between a television network and a producer is treated as a binding contract to produce property. In addition, a special rule is provided for certain films produced pursuant to a permanent financing arrangement described by the bill. For purposes of the placed-in-service requirement, films and sound recordings are treated as having ADR midpoints of 12 years.

Finance leases

The finance lease rules continue to apply to any transaction permitted by reason of section 12(c)(2) of DEFRA or section 209(d)(1)(B) of TEFRA.

Revenue Effect

The cost recovery provisions are estimated to increase fiscal year budget receipts by $8,254 million in 1986, $22,692 million in 1987, $20,229 million in 1988, $26,732 million in 1989, $34,637 million in 1990, and $44,791 million in 1991.

TITLE III—ACCOUNTING PROVISIONS

A. Limitations on the Use of the Cash Method of Accounting by Financial Institutions and Finance Companies (sec. 321 of the bill and sec. 448 of the Code)

Present Law

Under present law, a taxpayer generally may elect (on its first income tax return) to use any method of accounting for Federal income tax purposes that clearly reflects income and that is regularly used in keeping the taxpayer's books and records (sec. 446). The latter requirement is considered satisfied where the taxpayer maintains sufficient records to allow reconciliation of the results obtained under the method regularly used in keeping its books and the method used for Federal income tax purpose.

If the method chosen by the taxpayer fails to reflect income clearly, the Internal Revenue Service may require the taxpayer to use a method meeting the statutory standard (sec. 446(b)). The Internal Revenue Service has wide discretion in determining whether a particular method of accounting should be disallowed as not clearly reflecting income. Once a method of accounting has been selected by a taxpayer, a change to a different method requires the consent of the Internal Revenue Service.

Various methods of accounting are allowed under present law, including the cash receipts and disbursements method (cash method), the accrual method, certain industry specific methods, and, within certain limitations, hybrid methods combining several of the approaches of these and other methods.

The cash method generally recognizes items of income when actually or constructively received and items of expense when paid. The accrual method generally recognizes income when all events have occurred that establish the taxpayer's right to receive the income and the amount of the income can be established with reasonable accuracy. An item of expense is recognized when all events have occurred which establish an obligation to pay, the amount thereof can be determined with reasonable accuracy, and there has been economic performance with respect to that item.

Present law requires the use of the accrual method in certain situations. If the production, purchase, or sale of merchandise is a material income-producing factor to the taxpayer, the taxpayer is required to keep inventories and to use the accrual method of accounting with respect to inventory items (sec. 471; Treas. Reg. sec. 1.471-1). Also, certain corporations engaged in agricultural activities with gross receipts exceeding $1 million are required to use the accrual method of accounting (sec. 447).

Reasons for Change

The bill provides that financial institutions and finance companies should continue to be allowed to use the reserve method of computing losses from bad debts. The committee believes that taxpayers permitted to use the reserve method for accounting for bad debts also should be required to use the accrual method for other items of income and expense as well. Accordingly, the bill requires that all financial institutions and finance companies use the accrual method of accounting for Federal income tax purposes.

Explanation of Provision

The bill provides that financial institutions and finance companies may not use the cash method of accounting for Federal income tax purposes. The use of a hybrid method of accounting that records some, but not all, transactions using the cash method of accounting will be considered the same as the use of the cash method of accounting for this purpose.

For these purposes, a financial institution is any organization described in section 581 (relating to banks, including mutual savings banks, cooperative banks, or building and loan associations), section 586 (relating to small business investment companies and business development corporations), and section 166(c) (relating to banks for cooperatives and production credit associations). A finance company is any entity which is allowed, under the bill, to use the reserve method of computing losses from bad debts (See sec. 166(c) as revised by the bill).

The bill treats any change from the cash method of accounting required as a result of the bill as a change in the taxpayer's method of accounting, initiated by the taxpayer with the consent of the Secretary of the Treasury. In order to prevent items of income or expense from being included in taxable income either twice or not at all, an adjustment under section 481 is required to be made. The amount of such adjustment will be included in income over a period not to exceed five taxable years. It is expected that the concepts of Revenue Procedure 84-74, 1984-2 C.B. 736, generally will apply to determine the actual timing of recognition of income or expense as a result of the adjustment.

The bill does not change the rules of present law relating to what accounting methods clearly reflect income or the authority of the Secretary of the Treasury to require the use of an accounting method that clearly reflects income.

Effective Date

The provision is effective for taxable years beginning after December 31, 1986.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $79 million in 1987, $156 million in 1988, $177 million in 1989, $181 million in 1990, and $189 million in 1991.

B. Utilities Using Accrual Accounting (sec. 322 of the bill and sec. 451 of the Code)

Present Law

Present law requires taxpayers using the accrual method of accounting to recognize income at the time when all the events have occurred which establish the taxpayer's right to receive the income and the amount of income can be established with reasonable accuracy.

The Internal Revenue Service has allowed utilities to use a variation of the accrual method which recognizes income based upon the taxable year in which a customer's utility meter is read (the "cycle meter reading" method) (Revenue Ruling 72–114, 1972–1 C.B. 124). In addition, recent judicial decisions have expanded the use of the cycle meter reading method beyond the provisions of Revenue Ruling 72–114. *See, e.g., Orange and Rockland Utilities* v. *Commissioner*, 86 T.C. No. 14 (1986). Under the cycle meter reading method, if the meter reading date falls within the current taxable year, the income attributable to utility services provided on or before the reading date is included in gross income in that taxable year. Under this method, any utility services provided to customers within the current taxable year after the last meter reading date of such year will not be recognized as income until the following taxable year.

Present law is generally unclear with regard to the obligation of an accrual basis taxpayer to recognize income from the provision of services at the time that such services are provided to customers. Some courts have held that taxpayers are allowed to defer recognition of this income until such time as the taxpayer bills (or may bill) the customer for such services.

Reasons for Change

The committee believes that the cycle meter reading method of accounting incorrectly measures taxable income of utilities because the method does not require the recognition of income as the income is earned and because the method results in a mismatching of income and expense. For the same reasons, the committee believes that utilities not using customer meters should be required to recognize income as such income is earned, and not at some later date when the customer is billed (or may be billed) by the utility. Accordingly, the committee believes that utilities using the accrual method of accounting should be required to recognize income at the time that the utility services are provided, rather than at the time those services are billed, or at the time a utility meter is read.

Explanation of Provision

The provision requires accrual basis taxpayers to recognize income attributable to the furnishing or sale of utility services to customers not later than the taxable year in which such services are provided to the customer. Such services will normally be considered to be provided at the time that the services are made available to, and used by, the customer. For example, water would be considered as provided at the time that the the customer withdrew the water from the utility's delivery system. The year in which utility services are provided may not be determined by reference to the time the customer's meter is read or to the time that the customer is billed (or may be billed) for such services.

The effect of the provision is to require an estimate of the income attributable to utility services provided during the taxable year but after the final meter reading or billing date which falls within the taxable year. It is anticipated that, where it is not practical for the utility to determine the actual amount of services provided through the end of the current year, this estimate may be made by assigning a pro rata portion of the revenues determined as of the first meter reading date or billing date of the following taxable year.

Utility services subject to the provision are the provision of electrical energy, water or sewage disposal, the furnishing of gas or steam through a local distribution system, telephone and other communications services, and the transportation of gas or steam by pipeline. It is anticipated that similar rules also would be applicable to other utility services which might come into existence at some future date. Whether or not a utility service is regulated by a government or governmental agency does not affect its treatment under this provision.

The bill treats any change in method of accounting required by this provision as a change in the taxpayer's method of accounting, initiated by the taxpayer with the consent of the Secretary of the Treasury. In order to prevent any item of income from being included in taxable income either twice or not at all, an adjustment under section 481 is required to be made. The amount of such adjustment is to be taken into account ratably over a four-year period.

The committee intends that no inference be created by this provision as to the Federal income tax treatment of utility services under present law.

Effective Date

The provision is effective for taxable years beginning after December 31, 1986.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $191 million in 1987, $356 million in 1988, $384 million in 1989, $387 million in 1990, and $200 million in 1991.

C. Installment Sales (secs. 311 and 312 of the bill and secs. 453, 453A and 453C of the Code)

Present Law

In general

Under present law, gain or loss from a sale of property generally is recognized in the taxable year in which the property is sold. Nonetheless, gain from certain sales of property in exchange for which the seller receives deferred payments is reported on the installment method, unless the taxpayer elects otherwise (sec. 453). Eligible sales include dispositions of personal property on the installment plan by a person who regularly sells or otherwise disposes of personal property on the installment plan (sec. 453A) and other dispositions of noninventory property, including publicly traded property, where at least one payment is to be received after the close of the taxable year in which the disposition occurs (sec. 453(b)(1)). The installment method may not be used where a sale results in a loss.

Under the installment method, in any taxable year, a taxpayer recognizes income resulting from a disposition of property equal to an amount that bears the same ratio to the payments received in that year that the gross profit under the contract bears to the total contract price. Payments taken into account for this purpose generally include cash or other property (including foreign currency and obligations of third parties), marketable securities, certain assumptions of liabilities, and evidences of indebtedness of the purchaser that are payable on demand or are readily tradable (Temp. Treas. Reg. sec. 15A.453-1(b)(3)).

For example, assume property that has a basis of $50,000 is sold in a transaction eligible for installment reporting. The seller receives $40,000 immediately in cash and will receive $60,000 (plus interest at the current market rate) in the next taxable year. Under the installment method, the seller recognizes $20,000 of gain immediately — $50,000/$100,000 (gross profit ratio) times $40,000 (payments received). The seller recognizes the remaining $30,000 of gain when the final payment is received—$50,000/$100,000 times $60,000.

Sales under a revolving credit plan

Taxpayers, who sell property under arrangements commonly known as revolving credit plans, are permitted to treat a portion of the receivables arising from sales on such a plan as installment receivables and report income therefrom on the installment method (Treas. Reg. sec. 1.453-2(d)). In general, the regulations define a revolving credit plan to include a cycle budget account, a flexible budget account, a continuous budget account, and other similar ar-

rangements under which the customer agrees to pay a part of the outstanding balance of the customer's account during each period of time for which a periodic statement of charges and credits is rendered.

Dispositions of installment obligations

Generally, if an installment obligation is disposed of, gain (or loss) is recognized equal to either (a) the difference between the amount realized and the basis of the obligation in the case of satisfaction at other than face value, or sale or exchange of the obligation, or (b) the difference between the fair market value of the obligation at the time of the disposition and the basis of the obligation in the case of any other disposition (sec. 453B). The basis of the obligation is equal to the basis of the property sold plus amounts of gain previously recognized, less the amount of any payments received. In general, the mere pledge of an installment obligation as collateral for a loan is not treated as a disposition.[1]

Reasons for Change

Proportionate disallowance rule

In general, the underlying reason for allowing the reporting of gain on the installment method for Federal income tax purposes is that the seller may be unable to pay tax currently because no cash may be available until payments under the obligation are received. The committee believes that the ability to defer taxation under the installment sales method is inappropriate in the case of gains realized by dealers on ordinary income assets, and also with respect to gains realized on certain business or rental property, to the extent that the taxpayer has been able to receive cash from borrowings related to its installment obligations.

The committee believes that the borrowings of a taxpayer generally are related to its installment obligations in one of two ways. In general, either the taxpayer would not undertake all or a portion of the borrowings but for its extending credit in connection with the sale of its property or the taxpayer's borrowing ability is enhanced by the presence of the installment obligations among the taxpayer's assets. The committee recognizes, however, that it is extremely difficult to determine with any precision the extent of the nexus between the taxpayer's borrowings and its installment obligations. Hence, the committee believes it appropriate to adopt a rule which assumes that the borrowings of the taxpayer may be allocated among the taxpayer's assets on a pro rata basis. Nevertheless, the committee believes that farm property and personal use property, as well as indebtedness relating to such property, should not be taken into account.

The committee recognizes that arguments may be made that, in certain circumstances, a taxpayer's borrowings may appear to have no nexus whatsoever to its installment obligations, and that in other circumstances, a taxpayer's borrowings may appear to be so

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[1] *See, e.g., Town and Country Food Co., Inc.* v. *Commissioner,* 51 T.C. 1049 (1969), acq. 1969-2 C.B. XXV; *United Surgical Steel Company, Inc.* v. *Commissioner,* 54 T.C. 1215 (1970), acq. 1971-2 C.B. 3.

closely related to its installment obligations that the installment obligations could appropriately be treated as having been disposed of.[2] Nevertheless, rather than making necessary the difficult and subjective inquiry regarding the nexus between the borrowings of a taxpayer and its installment obligations, the committee believes that imposing a limitation based on a pro rata allocation of the taxpayer's borrowings is an appropriate accommodation of competing concerns.

The committee believes, however, it is appropriate to provide elective treatment for installment obligations arising from certain sales of real property or similar interests. These interests generally are "timeshares" and residential lots. The committee believes that taxpayers making such sales should not be subject to the proportionate disallowance rule if they elect to pay interest for the privilege of deferring the payment of their tax liability.

In addition, the committee believes that an exception should be provided for installment obligations arising from sales by a manufacturer to a dealer, where the term of the dealer's obligation is based on the time that the dealer resells or rents the property, where the seller has the right to repurchase the property after a specified period, and where the amount of the dealer's outstanding installment obligations is a significant percentage of its total sales to dealers. The committee believes that the taxpayer in such circumstances should not be required to recognize income under the proportionate disallowance rule because this type of arrangement sufficiently resembles a consignment arrangement of the dealer's inventory to warrant an exception from the general rule.[3]

Revolving credit plans and publicly traded property

In addition to the general limitation on the use of the installment method, the committee believes that two additional limitations should be imposed. First, the committee believes that sales under a revolving credit plan should not be permitted to be accounted for under the installment method. The committee believes that such sales more closely resemble the provision of a flexible line of credit accompanied by cash sales by the seller, and therefore is not appropriately afforded the use of the installment method. Second, the committee believes that the installment method should not be available for sales of certain publicly traded property. In general, publicly traded property is considered to be a sufficiently liquid asset to be treated the same as a payment of cash for purposes of applying the installment method. Moreover, since the taxpayer can easily sell such property for cash in the public market, the committee believes that such property does not present the same liquidity problem that the installment method is intended to alleviate.

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[2] The committee intends no change in present law regarding the circumstances under which an installment obligation may be treated as having been disposed of.

[3] The committee intends no inference regarding the treatment of any particular transactions as either sales or consignments.

Explanation of Provision

In general

In general, the bill limits the availability of the installment method of accounting in three circumstances. First, the bill disallows the use of the installment method with respect to a portion of certain installment receivables, based on the amount of the outstanding indebtedness of the taxpayer. The bill grants an election to taxpayers selling certain "timeshares" and residential lots whereby such taxpayers may elect to pay interest on the deferral of their tax liability and not be subject to the general rules under the bill relating to installment sales. In addition, the bill retains present law for certain installment obligations the term of which is dependent on the time of resale (or of the renting) of the property whose sale gave rise to the obligation.

Second, the bill prohibits taxpayers from using the installment method for sales pursuant to a revolving credit plan. Third, the bill provides that the installment method cannot be used for sales of certain publicly traded property.

Proportionate disallowance rule

In general

Under the bill, use of the installment method for certain sales by persons who regularly sell real or personal property described in section 1221(1), and for certain sales of business or rental property, is limited based on the amount of the outstanding indebtedness of the taxpayer. The limitation generally is applied by determining the amount of the taxpayer's "allocable installment indebtedness" ("AII") for each taxable year and treating such amount as a payment immediately before the close of the taxable year on "applicable installment obligations" of the taxpayer that arose in that taxable year and are still outstanding as of the end of the year.[4]

"Allocable installment indebtedness"

In general, AII for any taxable year is determined by (1) dividing the face amount of the taxpayer's "applicable installment obligations" that are still outstanding at the end of the year by the sum of (a) the face amount of all installment obligations (i.e., both applicable installment obligations and all other installment obligations) and (b) the adjusted basis of all other assets of the taxpayer,[5] (2) multiplying the resulting quotient by the taxpayer's average quarterly indebtedness, and (c) subtracting any AII that is attributable to applicable installment obligations arising in previous years. In the case of an individual, this computation does not take into account assets that are certain farm property or personal use property within the meaning of sec. 1275(b)(3) (including installment obligations arising from the sale of such property), or indebtedness that is secured by only such property.

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[4] The provisions of the bill do not affect the treatment of any payment (within the meaning of sec. 453(c)) prior to the close of the taxable year of sale, which payment would be accounted for under the ordinary rules for applying the installment method.

[5] Taxpayers may elect to use depreciation deductions as calculated under section 312(k) for purposes of computing the adjusted basis of its assets under this formula.

"Applicable installment obligations" are any installment obligations that arise from the sale after February 28, 1986, of (1) personal property on the installment plan by a person who regularly sells or otherwise disposes of personal property, (2) real property that is held by the taxpayer for sale to customers in the ordinary course of a trade or business, or (3) real property (other than certain farm property) used in the taxpayer's trade or business or held for the production of rental income, provided that the selling price of the property exceeds $150,000, so long as the obligation in any case is held by the seller or a member of the same affiliated group as the seller.

In each subsequent taxable year, the taxpayer is not required to recognize gain attributable to applicable installment obligations arising in any prior year to the extent that the payments on the obligations do not exceed the amount of AII attributable to such obligations. On the receipt of such payments, the AII attributable to the obligation on which the payment is received is reduced by the amount of such payments. Payments on an applicable installment obligation in excess of the AII allocable to such obligation are accounted for under the ordinary rules for applying the installment method.

In general, AII for a particular applicable installment obligation is not adjusted after its initial computation, except to reflect the receipt of payments on the installment obligation that do not result in the recognition of any additional gain. However, in order to assure that a proportionate share of a taxpayer's indebtedness is allocated to all installment obligations, additional AII may be allocated to installment obligations arising in previous years if the amount of AII for a particular taxable year exceeds the amount of applicable installment obligations arising in that year and outstanding at year end. In this situation, the amount of such excess is first allocated to (and treated as a payment on) outstanding applicable installment obligations that arose in the preceeding year (but only to the extent that the face amount outstanding exceeds the AII for such obligations), and then allocated in a similar fashion to each preceeding taxable year until the full amount of the excess is allocated.

Calculation of indebtedness

Under the bill, the taxpayer must compute its average indebtedness for the year in order to calculate the amount of its AII. The bill provides the calculation is to be made, for this purpose, on a quarterly basis. In making the calculation, all indebtedness of the taxpayer that is taken into account for purposes of the provision and that is outstanding as of the end of each quarter should be taken into account, including (but not limited to) accounts payable and accrued expenses as well as other amounts more commonly considered as indebtedness, such as loans from banks, and indebtedness arising from the issuance of bonds or in connection with the purchase of property by the taxpayer.[6] The committee recognizes

[6] Where any indebtedness of the taxpayer, or any applicable installment obligation is subject to the rules of either section 483 or section 1274, and either such section causes a portion of the

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that the extent to which indebtedness relating to accrued expenses and similar items is reflected in the computation may be diminished, for example, where a taxpayer regularly pays all of its accrued expenses and similar items at month end. However, the committee intends that any repayments of indebtedness for the purpose of avoiding this limitation be ignored for this purpose.

Affiliated groups

Where the taxpayer is a member of an affiliated group (within the meaning of sec. 1504(a), but without regard to sec. 1504(b)[6a]), or a group under common control (within the meaning of sec. 52(b)), then for purposes of making the calculations required under the bill, all such members are treated as one taxpayer. Thus, for purpcses of the bill, each member is treated as having all of the assets and liabilities of every other member. The committee intends that any indebtedness between members of the group, other than indebtedness that would be treated as an applicable installment obligation, would be disregarded (as both assets and liabilities) for this purpose. In addition, the committee intends that the adjusted basis of any asset transferred from one member of the group to another is to be reduced, for this purpose, by the portion of the gain that has not been recognized or otherwise has been deferred as of the time of the computation, either under the consolidated return regulations (see Treas. Reg. sec. 1.1504-13) or because the gain on the transfer was eligible to be reported under the installment method.

Thus, taxpayers who are members of such groups would compute AII on a group-wide basis for each taxable year. The AII so computed would then be allocated pro rata to the applicable installment obligations of all of the members of the group, and the allocated amount accordingly would be treated as a payment on the obligations.

The bill also provides that under regulations to be issued by the Secretary of the Treasury (which would be effective as of the time that the provisions of the bill are effective), use of the installment method would be disallowed in whole or in part where the provisions of the bill otherwise would be avoided through use of related parties or other intermediaries.

Example

The application of the rules of the bill may be illustrated by the following example. The example assumes that the taxpayer is a dealer in real property, uses the calendar year as its taxable year, and that its operations began in 1987.

Calendar year 1987.—During 1987, the taxpayer sells one property[7] for $90,000, taking back the purchaser's note for the entire pur-

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principal amount of such indebtedness or applicable installment obligation to be recharacterized as interest, then the provisions of the bill are to be applied based on the restated principal amounts.

[6a] For purposes of this provision, any shareholder who meets the stock ownership requirement of section 1504(a)(2) (taking into account all stock owned directly or indirectly by such shareholder) is treated as a member of the affiliated group.

[7] All sales referred to in the example are assumed to be of property that is held for sale to customers in the ordinary course of the taxpayer's trade or business. The facts of the example are intended only for purposes of illustrating the provisions of the bill limiting the use of the

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chase price.[8] The property was sold at a profit. No payments are received on the obligation before the end of the year.

The aggregate adjusted basis of the taxpayer's assets, other than the installment obligation,[9] is $310,000 as of the end of 1987. The taxpayer's average quarterly indebtedness for 1987 is $200,000.

The taxpayer's AII for 1987 would be $45,000. This amount is computed by multiplying (1) the taxpayer's average quarterly indebtedness for 1987 ($200,000) by (2) the quotient of (a) the total face amount of taxpayer's outstanding applicable installment obligations ($90,000) and (b) the sum of (i) the total face amount of the taxpayer's installment obligations ($90,000) and (ii) the adjusted basis of its other assets as of the end of 1987 ($310,000). The taxpayer would be treated as receiving a payment of $45,000 on the outstanding installment obligation as of the close of 1987.[10]

Calendar year 1988.—During 1988, the taxpayer sells another property for $110,000, taking back the purchaser's note for the entire purchase price. The property was sold at a profit. No payments were received in 1988 on either the 1987 or 1988 installment obligations held by the taxpayer.

The aggregate adjusted basis of the taxpayer's assets, other than the installment obligations, is $400,000 as of the end of 1988. The taxpayer's average quarterly indebtedness for 1988 is $300,000.

The taxpayer's AII for 1988 would be $55,000. This amount is computed by multiplying (1) the taxpayer's average quarterly indebtedness for 1988 ($300,000) by (2) the quotient of (a) the total face amount of the taxpayer's outstanding applicable installment obligations ($200,000) and (b) the sum of (i) the total face amount of the taxpayer's installment obligations ($200,000) and (ii) the adjusted basis of its other assets as of the end of 1988 ($400,000), and (3) subtracting the amount of AII allocated to applicable installment obligations that arose prior to 1988 ($45,000). The taxpayer would be treated as having received a payment of $55,000 on the installment obligation that arose in 1988, as of the close of 1988.

Calendar year 1989.—In 1989, the taxpayer sells a third property for $130,000. The property was sold at a profit. Also in 1989, the installment obligation that the taxpayer received in 1987 is paid in full. No payments are received on either the obligation that was received in 1988 or the one received in 1989.

The aggregate adjusted basis of the taxpayer's assets, other than its installment obligations, is $360,000 as of the end of 1989. The taxpayer's average quarterly indebtedness for 1989 is $500,000.

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installment method. The committee intends no inference regarding the circumstances under which property is properly considered to be held for sale to customers in the ordinary course of a trade or business.

[8] All installment obligations received in this example are assumed not to be payable on demand or readily tradable (within the meaning of sec. 453(f)). In addition, such installment obligations are assumed to have stated interest sufficient to avoid the recharacterizarion of any portion of the principal amount as interest under section 483 or section 1274. Payments referred to in the example are payments of principal on the obligations.

[9] It is assumed that none of the taxpayer's assets in the example other than its applicable installment obligations are installment obligations. If so, these assets would be taken into account at their face amount rather than their adjusted basis.

[10] Where the taxpayer has more than one applicable installment obligation outstanding as of the close of the taxable year, the amount of AII for the year would be allocated pro rata (by outstanding face amount) to the obligations, and the proportionately allocated amount would be treated as a payment on each respective outstanding obligation.

With respect to the $90,000 payment that was received on the installment obligation that arose in 1987, the first $45,000 of the payment would not result in the recognition of any additional gain with respect to the obligation, and would reduce the amount of AII that is treated as allocated to that obilgation. The next $45,000 would be treated as an additional payment on the obligation that results in the recognition of additional gain under the installment method.

Taking into account the payment on the 1987 installment obligation, the AII allocated to taxable years before 1989, for purposes of computing AII for 1989, would be $55,000 ($45,000 of AII from 1987 plus $55,000 of AII from 1988 minus $45,000 of AII from 1987 returned in 1989).

The taxpayer's AII for 1989 would be $145,000. This amount is computed by multiplying (1) the taxpayer's average quarterly indebtedness for 1989 ($500,000) by (2) the quotient of (a) the total face amount of the taxpayer's outstanding applicable installment obligations as of the end of 1989 ($110,000 plus $130,000, or $240,000) and (b) the sum of (i) the total face amount of the taxpayer's installment obligations ($240,000) and (ii) the adjusted basis of its other assets as of the end of 1989 ($360,000), and (3) subtracting the amount of AII allocated to applicable installment obligations that arose prior to 1989 ($55,000).

Since taxpayer's AII for 1989 ($145,000) exceeds the amount of applicable installment obligations arising in 1989 and outstanding at the end of the year ($130,000), the taxpayer is treated as having received a payment, as of the close of 1989, of $130,000 on the installment obligation that arose in 1989, and a payment of $15,000 (i.e., the excess of $145,000 over $130,000) on the installment obligation that arose in 1988.

Special election for sales of timeshares and residential lots

The bill provides an election under which the proportionate disallowance rule would not apply to installment obligations that arise from the sale of certain types of property by a dealer to an individual, but only if the individual's obligation is not guaranteed or insured by any third person other than an individual.[11] The obligation must arise from the sale of a "timeshare" or of unimproved land, the development of which will not be done by the seller of the land or any affiliate of the seller.[12]

For these purposes, a timeshare is a right to use a specified parcel of residential real property for a period not exceeding six weeks per year. The committee intends that where an individual or any related person owns more thap one timeshare in a single parcel of residential real property, then all of the timeshares of the individual and the related parties are aggregated for purposes of determining whether the six week test is met. In addition, for purposes of the provision, a timeshare may include a right to use

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[11] The committee intends that any Federal or private insurance relating to the payment of the individual's obligation would prevent the obligation from qualifying for the special election.

[12] The committee intends that a parcel of land is not to be considered to have been improved or developed if it merely has been provided with the benefits of common infrastructure items such as roads and sewers.

campground sites in designated locations over ascertainable periods of time for recreational (not residential) purposes.[13]

If these conditions are met, then the seller of the property that gave rise to these obligations may elect not to have the general rules of the bill relating to installment sales apply, provided that the seller pays interest on the deferral of its tax liability attributable to the use of the installment method.

Exception for certain sales by manufacturers to dealers

The bill provides an exception for installment obligations arising from the sale of tangible personal property by the manufacturer of the property (or an affiliate of the manufacturer) to a dealer,[14] but only if the dealer is obligated to make payments of principal only when the dealer resells (or rents) the property, the manufacturer has the right to repurchase the property at a fixed (or ascertainable) price after no longer than a nine month period following the sale to the dealer, and certain other conditions are met. In order to meet the other conditions, the aggregate face amount of the installment obligations that otherwise qualify for the exception must equal at least 50 percent of the total sales to dealers that give rise to such receivables (the "fifty percent test") in both the taxable year and the preceding taxable year, except that, if the taxpayer met all of the requirements for the exception in the preceding taxable year, then the taxpayer would not be treated as failing to meet the fifty percent test before the second consecutive year in which the taxpayer did not actually meet the test. For purposes of applying the fifty percent test the aggregate face amount of the taxpayer's receivables is computed using the weighted average of the taxpayer's receivables computed on a monthly basis. In addition, these requirements must be met by the taxpayer in its first taxable year beginning after the date of enactment of the bill. For purposes of this provision, obligations issued before the date of enactment are treated as meeting the applicable requirements if such obligations are conformed to the requirements of the bill within 60 days of the date of enactment of the bill.

Receivables that meet the conditions for the exception are not subject to the provisions of the bill relating only to limitation on the use of the installment method. The committee intends no inference regarding the treatment of these transactions for Federal income tax purposes.

Revolving credit plans

Under the bill, taxpayers who sell property on a revolving credit plan are not permitted to account for such sales on the installment method. For this purpose, the committee intends that the term "revolving credit plan" have the same meaning as that under present law (see Treas. Reg. sec. 1.453–2(d)).

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[13] The committee intends no inference whether income from transactions involving such "campground timeshares" may properly be accounted for on the installment method.

[14] *I.e.*, the sale of the property must be intended to be for resale or leasing by the dealer.

Publicly traded property

Under the bill, taxpayers who sell stock or securities that are traded on an established securities market, or to the extent provided in Treasury regulations, property (other than stock or securities) of a kind regularly traded on an established market, are not permitted to use the installment method to account for such sales. The committee understands that the fair market value of an installment obligation received in exchange for such property is to be considered to be the same as the fair market value of the property at the time of sale.

The committee intends that, in the case of sales that are made on an established market, where cash settlement of transactions customarily occurs several business days after the date on which a trade is made, that gain or loss would be recognized for Federal income tax purposes by both cash or accrual method taxpayers on the day that the trade is executed.

The bill also provides that, under regulations to be issued by the Secretary of the Treasury (which would be effective as of the time that the provisions of the bill are effective), use of the installment method may be disallowed in whole or in part where the provisions of the bill otherwise would be avoided through use of related parties or other intermediaries. The committee intends that such regulations would apply to sales of property, a substantial portion of whose value is attributable to property gain from the sale of which could not be reported on the installment method on account of the provisions of the bill. For example, if a taxpayer sells his interest in a wholly owned corporation the only assets of which are stock or securities that are traded on an established securities market, the Secretary of the Treasury may deny the use of the installment method to account for gain on the sale.

The committee intends that any Treasury regulations would not deny use of the installment method if the seller could not have sold, or caused the sale of, the publicly traded stock or securities directly. For example, a retiring partner in a large investment partnership makes an installment sale of his partnership interest, a substantial portion of the value of which is attributable to stocks and securities held by the partnership. Provided that the retiring partner could not have sold or caused the sale of the partnership's assets directly, the gain on the sale of the partnership interest may be reported on the installment method.

Effective Date

The elimination of the installment method for sales on a revolving credit plan and for sales of publicly traded property is effective for sales of property after December 31, 1986. Taxpayers, who sell property under revolving credit plans and who may no longer use the installment method of accounting for such sales, may include in income any adjustment resulting from their ceasing to use the installment method over a period not exceeding five years.

The proportionate disallowance rule is effective as of January 1, 1987, for sales made on or after March 1, 1986. Hence, a taxpayer would treat the outstanding balance of installment obligations arising on or after March 1, 1986, and before January 1, 1987, as

having arisen during its first taxable year beginning after December 31, 1986, for purposes of applying the rules of the bill. In addition, the bill does not treat certain specified loans as outstanding indebtedness for purposes of the proportionate disallowance rule.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $1,290 million in 1987, $1,713 million in 1988, $1,380 million in 1989, $1,394 million in 1990, and $1,431 million in 1991.

D. Capitalization of Inventory, Construction, and Development Costs (secs. 301 and 302 of the bill and new sections 263A and 460 of the Code)

Present Law

In general

Producers of property generally may not deduct currently the costs incurred in producing the property. Rather, such costs must be capitalized and recovered through an offset to sales price if the property is produced for sale, or through depreciation or amortization if the property is produced for the taxpayer's own use in a business or investment activity. Although substantially all direct production costs must be capitalized, the treatment of indirect costs may vary depending on the type of property produced. For example, different rules may apply depending on whether the property is fungible property held in inventory, nonfungible property held for sale to customers, or property produced under a long-term contract.

Purchases of goods for resale are subject to more liberal rules which require only that direct acquisition costs be inventoried.

Inventories

Taxpayers must maintain inventories[15] and generally must use the accrual method of accounting for purchases and sales for tax purposes whenever necessary to clearly determine their income (sec. 471). In general, all producers and sellers of goods must maintain inventories under methods prescribed by the Internal Revenue Service as conforming to the best accounting practice in the particular trade or business and as clearly reflecting income.

Purchased goods

In the case of purchased goods, a taxpayer must include in inventory the invoice price of the goods less any trade or other discounts. Cash discounts, approximating a fair interest rate, may be deducted or not at the taxpayer's option, provided a consistent practice is followed. Transportation or other necessary charges incurred in acquiring possession of the goods then are added to this adjusted invoice price in determining the total inventory costs.[16] Thus, for example, freight-in, brokerage or franchise service fees, and handling charges incurred in connection with a purchase of goods are includ-

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[15] The purpose of maintaining inventories is to assure that the costs of producing or acquiring goods are matched with the revenues realized from their sale. Inventory accounting accomplishes this by accumulating production or acquisition costs in an inventory account as they are incurred rather than allowing an immediate deduction when incurred. When the related goods are sold, these costs are removed from the inventory account and recorded as costs of sale, which reduce taxable income for the year of the sale.

[16] Treas. Reg. sec. 1.471-3(b).

ible in inventory costs.[17] The courts have generally held that storage and other costs incurred by the taxpayer while the goods are in its possession are not inventoriable costs but may be deducted currently.[18]

Manufactured goods

The Treasury regulations require that all direct and indirect "production costs" (costs incident to and necessary for production or manufacturing operations and processes) be included in an inventory account and not used to reduce taxable income until disposition of the goods to which they relate. The determination of which direct and indirect costs constitute production costs is made in accordance with the "full absorption" method.[19] Direct production costs required to be included in an inventory account include the costs of materials forming an integral part of the product or consumed in the manufacturing process, and the labor that is directly involved in fabrication of the product. Direct labor costs include not only wages and salaries of production workers and supervisors, but also such items as vacation and holiday pay, payroll taxes, and payments to supplemental unemployment benefit plans paid or incurred on behalf of employees engaged in direct labor.[20]

Under the full absorption method, indirect production costs are divided into three categories. Costs in Category 1 must be included in inventory costs; costs in Category 2 do not have to be included in inventory costs; and costs in Category 3 must be included in inventory costs only if they are included in inventory costs for purposes of the taxpayer's financial reports.

Category 1 costs.—Category 1 costs include:

(1) repair expenses,

(2) maintenance,

(3) utilities, such as heat, power, and light,

(4) rent,

(5) indirect labor and production supervisory wages, including basic compensation, overtime pay, vacation and holiday pay, shift differential, payroll taxes, and contributions to a supplemental unemployment benefit plan,

(6) indirect materials and supplies,

(7) tools and equipment not capitalized, and

(8) costs of quality control and inspection to the extent such costs are incident to and necessary for production or manufacturing operations or processes.[21]

Category 2 costs.—Category 2 costs include:

(1) marketing expenses,

(2) advertising expenses,

(3) selling expenses,

(4) other distribution expenses,

(5) interest,

(6) research and experimental expenses, including engineering and product development expenses,

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[17] See, e.g., Rev. Rul. 80-141, 1980-1 C.B. 111; *McDonald* v. *Commissioner*, 2 B.T.A. 906 (1925).
[18] See, e.g., *McIntosh-Mills* v. *Comm'r*, 9 B.T.A. 301 (1927), acq. VII-1 C.B. 21.
[19] Treas. Reg. sec. 1.471-11.
[20] Treas. Reg. sec. 1.471-11(b)(2).
[21] Treas. Reg. sec. 1.471-11(c)(2)(i).

(7) losses under section 165,
(8) percentage depletion in excess of cost depletion,
(9) depreciation and amortization reported for Federal income tax purposes in excess of depreciation reported for financial statement purposes,
(10) income taxes attributable to income received on the sale of inventory,
(11) pension contributions to the extent they represent past services costs,
(12) general and administrative expenses incident to and necessary for the taxpayer's activities as a whole rather than to production or manufacturing operations or processes, and
(13) salaries paid to officers attributable to the performance of services that are incident to and necessary for the taxpayer's activities as a whole, rather than to production or manufacturing operations.[22]

Category 3 costs.—Category 3 costs include:
(1) taxes otherwise allowable as a deduction under section 164 (other than State and local and foreign income taxes) attributable to assets incident to and necessary for production or manufacturing operations,
(2) depreciation reported on financial statements and cost depletion on assets incident to and necessary for production or manufacturing operations or processes,
(3) pension and profit-sharing contributions representing current service costs otherwise allowable as a deduction under section 404, and other employee benefits incurred on behalf of labor incident to and necessary for production or manufacturing operations or processes,
(4) costs attributable to rework labor, scrap, spoilage, and strikes that are incident to and necessary for production or manufacturing operations or processes,
(5) factory administrative expenses (not including any cost of selling or any return of capital),
(6) salaries paid to officers attributable to services performed incident to and necessary for production or manufacturing operations or processes, and
(7) insurance costs incident to and necessary for production or manufacturing operations or processes (e.g., insurance on production machinery and equipment).[23]

If a taxpayer uses a method of accounting for financial reporting purposes that would not be allowable for Federal income tax purposes (such as the "prime cost" method, which includes as inventory costs only direct costs), taxes, depreciation, production-related officers' salaries, and insurance costs must be taken into account in inventory. Employee benefit costs and costs attributable to strikes, rework labor, scrap, and spoilage are treated as Category 2 costs and need not be included in inventory costs.[24]

Indirect production costs required to be treated as inventory costs must be allocated to goods in a taxpayer's ending inventory

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[22] Treas. Reg. sec. 1.471-11(c)(2)(ii).
[23] Treas. Reg. sec. 1.471-11(c)(2)(iii).
[24] Treas. Reg. sec. 1.471-11(c)(3).

using a method of allocation that fairly apportions such costs among the goods produced. The regulations authorize use of either the standard cost method or the manufacturing burden rate method. In general, the standard cost method assigns a predetermined rate (e.g., $X per direct labor hour) for each element of product cost, including direct materials and labor and fixed and variable overhead. The manufacturing burden rate method is similar to the standard cost method but assigns predetermined rates only to overhead costs.

Self-constructed property and nonfungible property produced for sale

Under present law, the costs of acquiring, constructing, or improving buildings, machinery, equipment, or other assets having a useful life that extends substantially beyond the end of the taxable year are not currently deductible (sec. 263).[25] Rather, such "capital" expenditures become part of the basis of the acquired, constructed, or improved property. These costs may be recoverable over the useful life of the property through depreciation or amortization deductions if the property is used in a business or investment activity and has a determinate useful life, and is therefore subject to an allowance for depreciation or amortization. Otherwise, such costs are recoverable when the property is sold or otherwise disposed of. At the time of sale or other disposition, any unrecovered basis of the asset is offset against the amount realized in computing gain or loss.

A taxpayer that constructs a building or other capital asset for its own use must capitalize all direct construction costs such as direct materials and labor. Moreover, depreciation on the taxpayer's equipment used to construct the property may not be deducted currently but must be capitalized into the basis of the self-constructed property.[26]

The proper tax treatment of many indirect expenses incurred in connection with the self-construction of property, however, is less certain. One line of cases refers to the authority of section 446(b), which requires use of an accounting method that clearly reflects income, and to the Supreme Court's holding in *Idaho Power Co.* v. *Commissioner* in holding that vacation pay, payroll taxes, health and welfare benefits, and general overhead costs and executive salaries attributable to self-construction must be capitalized rather than deducted currently.[27] Other cases have used a facts and circumstances test and ruled that such indirect costs need be capitalized only to the extent they are incremental or variable overhead

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[25] See also, Treas. Reg. secs. 1.263(a)-2(a); 1.263(a)-1(b); 1.446-1(a)(4)(ii); 1.461-1(a)(2).

[26] *Idaho Power Co.* v. *Commissioner*, 418 U.S. 1 (1974).

[27] See, e.g., *Adolph Coors Co.* v. *Commissioner*, 519 F.2d 1280 (10th Cir. 1975), cert. denied, 423 U.S. 1087 (1976) (Internal Revenue Service is justified in requiring capitalization of overhead costs of construction); *Louisville & Nashville R.R. Co.* v. *Commissioner*, 641 F.2d 735, (6th Cir. 1981), aff'g, rev'g, and remanding 66 T.C. 962 (1976) (upholding Tax Court's determination that vacation pay and health and welfare benefits were subject to capitalization, but reversing as to payroll taxes); *Variety Construction Co.* v. *Commissioner*, T.C. Memo 1962-257 (1962) (overhead costs held subject to capitalization).

costs, that is, to the entent they exceed fixed overhead or vary significantly with the level of self-construction.[28]

Under the Treasury regulations, the use of "incremental" costing for indirect costs (in lieu of full absorption costing) is expressly proscribed in the case of inventory but no such prohibition applies for self-constructed property. In some instances, the Internal Revenue Service has acknowledged the deductibility of certain indirect costs incurred during self-construction. In *Idaho Power*, for example, the Service conceded that the taxpayer was entitled to deduct payroll taxes incurred with respect to employees engaged in construction of the property.

Long-term contracts

Special accounting rules may apply to taxpayers providing goods under certain types of contracts spanning two or more taxable years. A taxpayer with income and expenses from "long-term contracts" may report under the traditional cash or accrual methods which are, subject to the restrictions previously mentioned,[29] generally available to all taxpayers. At the taxpayer's election, however, income and expenses attributable to long-term contracts may be accounted for under one of two alternative methods — the percentage of completion method or the completed contract method.

A long-term contract for this purpose is a building, installation, construction, or manufacturing contract that is not completed by the end of the taxable year in which it is entered into. A manufacturing contract qualifies, however, only if it involves the manufacture of either unique items of a type not normally carried in the finished goods inventory of the taxpayer, or items normally requiring more than 12 months to complete.[30]

Percentage of completion method.—Under the percentage of completion method, income is recognized according to the percentage of the contract that is completed during each taxable year. The determination of the portion of the contract completed during the taxable year may be made by either (i) comparing the costs incurred during the year to the total estimated costs to be incurred under the contract, or (ii) comparing the work performed during the year with the estimated total work to be performed.[31] All costs attributable to the long-term contract are deductible in the year in which they are incurred, although a contractor must maintain inventories for materials and supplies.

Completed contract method.—Under the completed contract method, the entire gross contract price is included in income in the taxable year in which the contract is finally completed and accepted. All costs properly allocable to a long-term contract are deducted in the year of completion.

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[28] *Fort Howard Paper Co.* v. *Commissioner*, 49 T.C. 275 (1967) (incremental method and full absorption method equally permissible because taxpayer used the method for 35 years and the Internal Revenue Service had previously audited the taxpayer and did not object). See also I.T. 2196, IV-2 C.B. 112 (1925); *Paducah Water Co.* v. *Commissioner*, 33 F.2d 559 (D.C. Cir. 1929).

[29] For example, the cash method normally may not be used by a taxpayer required to maintain inventories.

[30] Treas. Reg. sec. 1.451-3.

[31] Treas. Reg. sec. 1.451-3(c)(2).

Regulations adopted in 1976 provide detailed rules for the allocation of costs between contract and non-contract costs. These costing rules essentially parallel the full absorption rules, except that, under the completed contract method, most Category 3 costs must be treated as contract costs. Thus, unless a contract is subject to the "extended period long-term contract" rules described below, the following costs are not contract costs: marketing and selling expenses (including the cost of developing bids); advertising expenses; distribution expenses; interest; general and administrative expenses attributable to the performance of services that benefit the contractor's activities as a whole (e.g., payroll, legal, and accounting expenses); research and experimental expenses under section 174; losses under section 165; percentage depletion in excess of cost depletion; depreciation and amortization on idle equipment and facilities; the excess of depreciation or amortization reported for tax purposes over that reported on financial statements; income taxes attributable to income received from long-term contracts; pension and profit-sharing contributions and other employee benefits (whether representing past or current service costs); costs attributable to strikes, rework labor, scrap, and spoilage; and salaries of officers that benefit the contractor's activities as a whole.

In the Tax Equity and Fiscal Responsibility Act of 1982, P.L. 97-248 (TEFRA), Congress directed the Treasury Department to modify the rules relating to allocation of costs to long-term contracts. In the case of "extended period" long-term contracts—those that are not expected to be completed within 24 months from the contract commencement date—certain costs previously not treated as contract costs must be allocated to the contracts to the extent they either directly benefit or were incurred by reason of such contracts. These costs include:

(1) bidding expenses on contracts awarded to the taxpayer;

(2) distribution expenses, such as shipping costs;

(3) general and administrative expenses properly allocable to long-term contracts under regulations prescribed by the Treasury Department;

(4) research and development expenses that either are directly attributable to particular long-term contracts existing when the expenses are incurred, or are incurred under an agreement to perform research and development;

(5) depreciation, capital cost recovery, and amortization for equipment and facilities currently being used in the performance of extended period long-term contracts, in excess of amounts reported for financial accounting purposes;

(6) pension and profit-sharing contributions representing current service costs, and other employee benefits;

(7) rework labor, scrap, and spoilage; and

(8) percentage depletion in excess of cost depletion.

An exception to these rules is provided for contracts for the construction of real property if the contract is expected to be completed within three years, or if the contractor's average annual gross receipts for the three taxable years preceding the year of the contract do not exceed $25 million. The regulations as adopted in 1976 continue to apply to these construction contracts and to all other long-term contracts expected to be completed within two years.

The legislative history of TEFRA expresses Congress' intention that the portion of the taxpayer's general and administrative expenses that directly benefits extended period long-term contracts must be allocated to such contracts, even though the same type of costs also benefits other activities of the taxpayer. However, general and administrative expenses that are incurred in the operation of the taxpayer's general management or policy guidance functions (for example, salaries of financial officers) are currently deductible.[32]

The Treasury Department recently issued final regulations reflecting the TEFRA modifications and clarifications.[33] Under the regulations, the principal distinctions between the treatment of long-term contracts and the treatment of extended period long-term contracts involve: the deductibility of depreciation (in the case of assets used in the performance of particular long-term contracts, only book depreciation must be allocated to contracts in the former, whereas all such depreciation must be allocated to contracts in the latter); the deductibility of current-service pension costs (deductible for the former but not the latter); general and administrative expenses (deductible for the former if beneficial to the taxpayer's activities as a whole, but in most instances partially allocable to the contract for the latter) and the deductibility of research and experimental costs (deductible for the former, but treated as contract costs for the latter if directly related to a particular contract or incurred under an agreement to perform research).[34]

In addition, rework labor, scrap, and spoilage costs are allocated to the contract in the case of extended period long-term contracts, but not for other long-term contracts.

Consistent with the TEFRA legislative history, the regulations adopt an expansive view of general and administrative expenses that directly benefit extended period long-term contracts and therefore must be allocated to such long-term contracts. Examples of the types of functions the cost of which ordinarily are required to be allocated include administration of manufacturing or construction projects, personnel operations, purchasing operations, materials handling and warehousing operations, accounting and data services operations related to contract activities, data processing, security services, and legal departments that provide legal services with respect to contracts. Functions for which allocation of costs ordinarily is not required include overall management and policy guidance (e.g., services by the board of directors and the chief executive, financial, legal, and accounting officers if no substantial part of their services relate to a particular contract), general financial planning and management, financial accounting, tax services, public relations, and internal audit.[35]

Interest and taxes incurred during construction

Interest and taxes incurred by a taxpayer during construction or improvement of real property (other than low-income housing) to

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[32] S. Rept. No. 97-530, 97th Cong., 2d Sess. (1982), at p. 547.
[33] Treasury Decision 8067, 51 Fed. Reg. 376 (January 6, 1986).
[34] See Treas. Reg. sec. 1.451-3(d)(5), (6).
[35] Treas. Reg. sec. 1.451-3(d)(9)(vi).

be used or held for sale in a trade or business or used in an activity for profit generally must be capitalized and amortized over 10 years (sec. 189). The construction period commences with the date on which construction of the building or other improvement begins and ends on the date it is ready to be placed in service or held for sale.[36]

The legislative history of amendments to section 189 indicates Congress' intention that the Treasury Department issue regulations allocating interest to expenditures for real property during construction consistent with the method prescribed by Financial Accounting Standards Board Statement Number 34 (FAS 34). Under FAS 34, the amount of interest to be capitalized is the portion of the total interest expense incurred during the construction period that could have been avoided if funds had not been expended for construction. Interest expense that could have been avoided includes interest costs incurred by reason of additional borrowings to finance construction, and interest costs incurred by reason of borrowings that could have been repaid with funds expended for construction.[37]

No regulations relating to this provision have been proposed or adopted to date.

Reasons for Change

Production, acquisition, and carrying costs

The committee believes that the present-law rules regarding the capitalization of costs incurred in producing property are deficient in two respects. First, the existing rules may allow costs that are in reality costs of producing, acquiring, or carrying property to be deducted currently, rather than capitalized into the basis of the property and recovered when the property is sold or as it is used by the taxpayer. This produces a mismatching of expenses and the related income and an unwarranted deferral of taxes. Second, different capitalization rules may apply under present law depending on the nature of the property and its intended use. These differences may create distortions in the allocation of economic resources and the manner in which certain economic activity is organized.

The committee believes that, in order to more accurately reflect income and make the income tax system more neutral, a single, comprehensive set of rules should govern the capitalization of costs of producing, acquiring, and holding property, including interest expense, subject to appropriate exceptions where application of the rules might be unduly burdensome.

Long-term contracts

The committee believes that the rules applicable to non-extended period long-term contracts also result in a mismatching of income and expense, and that the more comprehensive capitalization rules (including a rule requiring the capitalization of interest) should generally apply to all long-term contracts. In addition, the committee believes that there is no justification for allowing taxpayers

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[36] See H. Rep. No. 97-760, 97th Cong., 2d Sess. (1982) at p. 485.
[37] Id.

using any method of accounting for such contracts, other than the percentage of completion method, to deduct general and administrative costs that are clearly identifiable, by virtue of Federal certification requirements or (in the case of cost-plus contracts) the terms of the contract, as contract costs. These costs are necessarily associated with a particular contract and will be directly reflected in the contract price; they should therefore be accumulated and deducted only when the related income is reported by the taxpayer.

Explanation of Provisions

The bill requires application of a uniform set of capitalization rules to all costs incurred in manufacturing or constructing property or in purchasing and holding property for resale. In addition, interest costs generally will be subject to capitalization in cases where the interest is allocable to construction of real property, or to production of personal property that is long-lived property to be used by the taxpayer, or that requires an extended period to produce. The rules do not apply, however, to products produced in a farming business.

1. Uniform capitalization rules

Scope and nature of rules

Uniform capitalization rules prescribed by the Treasury Department will govern the inclusion in inventory or capital accounts of all costs (1) incurred in manufacturing, construction, and other types of activities involving the production of real or personal property, or (2) incurred in acquiring or holding such property for resale. Thus, the rules will apply to assets to be held by a taxpayer in inventory or for sale to customers in the ordinary course of business, and to assets or improvements to assets constructed by a taxpayer for its own use in a trade or business or in an activity engaged in for profit. The rules apply to intangible as well as to tangible property. However, the committee does not intend to modify present-law principles governing the determination of whether an expenditure results in a separate and distinct asset that has a useful life substantially beyond the taxable year.[38] Thus, if the costs of producing an intangible item such as goodwill are deductible under current law, such costs will continue to be deductible under the bill. The uniform capitalization rules merely will prescribe which costs associated with an asset required to be capitalized must be included in its basis or otherwise capitalized.

The uniform capitalization rules will be patterned after the rules applicable to extended period long-term contracts, set forth in the final regulations issued under section 451. Accordingly, taxpayers subject to the rules will be required to capitalize not only direct costs but also an allocable portion of most indirect costs that benefit the assets produced or acquired for resale, including general and administrative and overhead costs and other costs described in section 1.451-3 of the regulations. The committee recognizes that modifications of the rules set forth in the long-term contract regu-

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[38] See Treas. Reg. sec. 1.263(a)-1,(a)-2; *Commissioner* v. *Lincoln Savings and Loan*, 403 U.S. 345 (1971).

lations may be necessary or appropriate in order to adapt such rules to production not involving a contract, and intends that the Treasury Department will have the authority to make such modifications. The existing long-term contract regulations provide a large measure of flexibility to taxpayers in allocating indirect costs to contracts inasmuch as they permit any reasonable method of allocation authorized by cost accounting principles. The committee expects that the regulations under this provision will adopt a similarly liberal approach and permit allocations of costs among numerous items produced or held for resale by a taxpayer to be made on the basis of burden rates or other appropriate methods similar to those provided under present law.[39] The regulations may adopt other simplifying methods and assumptions where, in the judgment of the Secretary of the Treasury, the costs and other burdens of literal compliance may outweigh the benefits.

Retailers and wholesalers

In general, the uniform capitalization rules will apply to taxpayers who acquire and hold property for resale in the same manner as they apply to producers. Among the costs "retailers and wholesalers" are required to treat as inventory costs under the bill are the following: costs incident to purchasing inventory (e.g., wages or salaries of employees responsible for purchasing); repackaging, assembly, and other costs incurred in processing goods while in the taxpayer's possession; costs of storing goods (e.g., rent or depreciation, insurance premiums, and taxes attributable to a warehouse, and wages of warehouse personnel);[40] and the portion of general and administrative costs allocable to these functions.[41]

The committee intends that, in the case of a taxpayer engaged in a retail sales business, however, only offsite storage costs—that is, costs of storing goods in a facility distinct from the facility wherein the taxpayer conducts retail sales of these goods—will be inventoriable costs under this provision. The rules relating to capitalization of interest do not apply to real or personal property solely acquired for resale.

Pension costs

Under the uniform capitalization rules, contributions to a pension, profit-sharing, or stock bonus plan and other employee benefit expenses are considered indirect costs that must be capitalized to the same extent as other indirect costs, unless such contributions relate to past-service costs.[42] It is intended that, in the case of a contribution to a qualified plan, the determination of whether the contribution relates to past or current services will be made inde-

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[39] See Treas. Reg. sec. 1.471-11(d) (authorizing use of the manufacturing burden rate method, the standard cost method, or any other method that fairly apportions such costs among items of inventory).

[40] The committee intends that storage costs incurred by a manufacturer following completion (or substantial completion) of the manufacturing process with regard to a product will likewise be subject to capitalization under these rules. Thus, the bill overrules any case law holding to the contrary (without inference as to the validity of such cases under present law). See, e.g., *Heaven Hill Distilleries, Inc.* v. *U.S.*, 476 F.2d 1327 (Ct.Cl. 1973) (holding that storage costs incurred by the manufacturer of whisky during the aging process were currently deductible), and *Van Pickerill & Sons, Inc.* v. *U.S.*, 445 F.2d 918 (7th Cir. 1971).

[41] No inference is intended regarding the deductibility of such costs under present law.

[42] See Treas. Reg. sec. 1.451-3(d)(6)(iii)(I).

pendently of any allocation between "normal cost" and "past-service cost" required under the minimum funding standards (sec. 412) or under the plan's benefit formula. The committee anticipates that the Treasury Department will publish guidelines for making this determination, and that such determination may be based, in whole or in part, on any actuarial funding methods that may be utilized by qualified defined benefit plans.

Any allocation of employee benefit costs (and any other costs) between production (or inventory, in the case of purchased goods) costs and period costs will, of course, be made after application of any other relevant limitations provided in the Code. For example, in the case of a qualified defined benefit pension plan that is subject to the minimum funding standard, an employer will first, calculate his liability under the minimum funding standards (using the applicable funding method and actuarial assumptions); next, calculate the limit on deductions for such contributions (pursuant to section 404 of the Code); and finally, allocate the otherwise deductible amount between production costs and other costs applying the uniform capitalization rules. In applying these rules, the allocation of the otherwise deductible amount between past- and current-service costs will be made independently of the allocation made in the first step of the calculation, under rules published by the Treasury Department.

Similarly, in the case of a plan that is not subject to the minimum funding standards (e.g., a profit-sharing plan), an employer must compute the otherwise allowable deduction limit pursuant to section 404 and then allocate that amount between production or inventory costs and other costs.

Exceptions

The capitalization rules do not apply to any portion of costs constituting research and experimental expenditures under section 174, or to development and other costs of oil and gas wells or mineral property to the extent such costs qualify under sections 263(c) or 616(a). The rules also do not apply to property produced under a long-term contract; to property produced in a farming business as defined in section 2032A; or to property produced by the taxpayer for use by the taxpayer other than in a trade or business or activity engaged in for profit.

In the case of a property acquired by a taxpayer for resale, the uniform capitalization rules apply only if the taxpayer's average annual gross receipts for the three preceding taxable years were $5 million or less. Aggregation rules will apply in determining whether the $5 million threshold is exceeded.

The uniform capitalization rules are not intended to apply to expenditures properly treated as repair costs under present law that do not relate to the manufacture, remanufacture, or production of property. Moreover, the uniform capitalization rules are not intended to modify present law rules relating to valuation of inventories on a basis other than cost.

2. Interest

Interest on debt must be capitalized if such debt is incurred or continued to finance the construction or production of (1) real prop-

erty (whether such property is held for sale to customers or is used by the taxpayer in a trade or business or activity for profit), or (2) other property with a class life of 20 years or more under the bill's depreciation system if the property is to be used by the taxpayer in its trade or business or an activity for profit. Interest incurred in connection with other property estimated to have a production period of more than two years (one year in the case of items costing more than $1 million) also is subject to capitalization under this rule. For this purpose, the production period for property begins when construction or production is commenced and ends when the property is ready to be placed in service or is ready to be held for sale. For example, in the case of property such as wine or whisky that is aged before it is sold, the production period includes the aging period. Activities such as planning or design generally do not cause the production period to begin.

The committee intends that the determination of whether debt is incurred or continued to finance the production of property will be made under rules similar to those applicable under section 189 of present law.[43] Under these rules, any interest expense that would have been avoided if production or construction expenditures had been used to repay indebtedness of the taxpayer is treated as construction period interest subject to capitalization.[44] Accordingly, under the bill, debt that can be specifically traced to production or construction expenditures first must be allocated to production or construction. If production or construction expenditures exceed the amount of this debt, interest on other debt of the taxpayer must be treated, to the extent of this excess, as production or construction period interest. For this purpose, the assumed interest rate would be an average of the rates on the taxpayer's outstanding debt (excluding debt specifically traceable to production or construction).

The committee contemplates that the Treasury Department will issue regulations to prevent the avoidance of these rules through the use of related parties. For example, such regulations could provide that where a subsidiary corporation is owned by two 50-percent parent corporations, and the subsidiary is engaged in constructing long-lived property for its own use, but has no outstanding debt, each 50-percent parent would be required to capitalize interest expense as if each had directly incurred one-half of the construction expenditures incurred by the subsidiary. In addition, under the bill, the interest capitalization rules are applied first at the level of a partnership (or other flow-through) entity, and then at the level of the partners (or beneficiaries), to the extent that the partnership has insufficient debt to support the production or construction expenditures.

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[43] The provisions under section 189 of present law regarding capitalization of taxes have been replaced by similar rules, in the extended period long-term contract regulations, which also require the capitalization of taxes.

[44] Production or construction expenditures include the cumulative production costs required to be capitalized, including interest required to be capitalized as a production or construction cost for prior periods. In addition, interest on debt that relates to any asset that is devoted to the production of property generally must be capitalized as part of the cost of that property, whether or not the cost of the asset has been fully reflected in the property account. Where such an asset is used for the production of property and for other purposes, only the allocable portion of such interest must be capitalized.

If production or construction is for a particular customer who makes progress payments or advance payments for property to be used in a business or activity for profit, or held for sale, the customer is treated as constructing the property to the extent of such payments. Thus, interest costs attributable to payments to the contractor are subject to capitalization by the customer if the property is real property, long-lived property or requires a production or construction period of more than two years (one year if the cost exceeds $1 million). The contractor must capitalize interest only with respect to indebtedness relating to the excess of its accumulated contract costs over the accumulated payments received by the contractor during the year.

3. Long-term contract costs

Under the bill, taxpayers reporting income on a long-term contract under a method other than the percentage of completion method (including the accrual-shipment method or other accrual method of accounting) are subject to the capitalization rules now applicable to taxpayers using the completed contract method of accounting with respect to extended period long-term contracts, with certain modifications. Such taxpayers also must capitalize any other costs identified by the taxpayer (or a related person) as being attributable to the contract. Thus, for example, general and administrative expenses identified pursuant to a cost-plus contract, or pursuant to a contract with a Federal agency in which costs are certified under Federal statute or regulations, must be capitalized, regardless of whether such costs may be treated as period costs under existing regulations. Research and development costs unrelated to a particular contract, marketing, selling, and advertising expenses, and unsuccessful bid and proposal costs, are exempt from the capitalization requirement, as under present law.[45]

These rules do not apply to any contract for the construction or improvement of real property if the contract (1) is expected to be completed within the two-year period beginning on the commencement date of the contract, and (2) is performed by a taxpayer whose average annual gross receipts for the three taxable years preceding the taxable year in which the contract is entered into do not exceed $10 million. For purposes of this exception, an improvement to real property includes a building, a road, a dam, or other similar property. Contracts eligible for this exception, and contracts reported under the percentage of completion method, will remain subject to the rules of present law.

Interest incurred in connection with a long-term contract generally must be allocated under the same rules (including the avoided cost principle) as interest allocable to property not produced under a long-term contract. In applying these rules to a long-term contract, the production period generally begins on the contract commencement date, that is, the date on which the taxpayer incurs any costs under the contract. Design and engineering costs, but not costs related to bidding or negotiations on the contract, are taken into account for this purpose. The production period ends on the

[45] Bid and proposal costs may be treated as unsuccessful for this purpose only after the taxpayer has withdrawn its bid or the contract has been awarded to another person.

contract completion date. A special rule applies in the case of a taxpayer not using the completed contract method of accounting. For such a taxpayer, the production period begins on the date by which at least five percent of the total estimated costs (including design and planning costs) under the contract have been incurred, if later than the contract commencement date.

Effective Dates

In general

The uniform capitalization rules generally are effective for costs and interest paid or incurred after December 31, 1986. Self-constructed assets with respect to which substantial construction occurred prior to March 1, 1986, will remain subject to the present-law tax accounting rules. The committee intends that construction of an asset which began after February 28, 1986, will be considered within this transitional rule if the asset is an integral part of an integrated facility, construction of which began before March 1, 1986. An asset generally will be considered an integral part of a facility only if such asset will first be placed in service at essentially the same time as other assets comprising the facility.

The bill also retains present law rules for depreciation on assets used to produce inventory or self-constructed property if the assets were placed in service by the taxpayer before March 1, 1986, or the taxpayer had entered into a binding contract to purchase the assets prior to that date. Accordingly, such assets will be subject to present-law rules relating to the capitalization of depreciation.

Long-term contracts

The new rules for long-term contracts, including the interest capitalization provision and provision relating to cost-plus and Federal contracts, apply to contracts entered into after February 28, 1986.

Inventories

In general

The new rules apply to inventories for the taxpayer's first taxable year beginning after December 31, 1986. Taxpayers are required to spread the section 481 adjustment resulting from the change in inventory accounting over a period of no more than five years, in accordance with the rules applicable to a change in method of accounting initiated by the taxpayer and approved by the Internal Revenue Service.[46] Under these rules, the adjustment generally is includible in income over a period equal to the lesser of the period the taxpayer has used the method of accounting or five years.

With respect to property which is primarily held for sale to customers in the ordinary course of business, but which is not inventory property, the rules are effective for costs and interest paid or incurred after December 31, 1986, with no restatement of beginning balances and no section 481 adjustment. *E.g., see W.C. & A.N. Miller Development v. Commissioner,* 81 T.C. 619 (1983).

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[46] See Rev. Proc. 84-74, 1984-2 C.B. 736.

The bill contemplates that the changes in the rules governing the absorption of costs into inventory will be treated as a change in the taxpayer's method of accounting. The cost of all inventory sold or otherwise disposed of after the effective date must reflect the changes in the absorption rules. This requires that inventory on hand as of the effective date be revalued to reflect the greater absorption of production costs under the rules of the bill. Normally, the revaluation must be done by valuing the items included in inventory on the effective date as if the new absorption rules had been in effect during all prior periods. Thus, a determination of what direct and indirect production costs should be assigned to each item of inventory is to be made in accordance with the changes contained in the bill. The difference between the inventory as originally valued and the inventory as revalued will be the amount of adjustment required by section 481.

In some circumstances, particularly where the taxpayer is considered as holding in inventory items which were acquired for resale, produced, or manufactured a number of years prior to the effective date of the bill, the information necessary to make such a determination may not be available. Such a situation may arise, for example, if the taxpayer has items of inventory which it no longer produces, or if the taxpayer is using the last-in, first-out (LIFO) method of accounting. The committee expects that the Treasury Department will issue regulations or rulings permitting a taxpayer in this situation to estimate the amount by which the inventory will be revalued by using available data.

FIFO method

For example, assume that a taxpayer that uses the first-in, first-out (FIFO) method of valuing inventories maintains inventories of bolts, two types of which it no longer produces. Bolt A was last produced in 1984, for which year the taxpayer determines a revaluation of inventory costs resulting in a 20 percent increase. A portion of the inventory of bolt A, however, is attributable to 1983 for which the taxpayer does not have sufficient data for revaluation. Bolt B was last produced in 1982 and no data exists which would allow revaluation of the inventory cost of bolt B pursuant to the new absorption rules. The inventories of all other bolts are attributable to 1984 and 1985 production, for which revaluation using available data results in an average 15 percent increase in inventory cost. With respect to bolt A, the 20 percent increase determined for 1984 also may be applied to the 1983 production as an acceptable estimate. With respect to bolt B, the overall 15 percent increase for the inventory as a whole may be used in valuing the costs of bolt B.

LIFO method

Taxpayers using the last-in, first-out (LIFO) method of valuing inventories also may have difficulty in assembling sufficient data to restate their inventory costs. Taxpayers using the dollar-value LIFO method may have particular problems since the valuation of each year's LIFO layer is dependent upon prior year's cost data in situations where the double extension method is used.

The committee expects that taxpayers using the specific goods LIFO method to value their inventories generally will be allowed to use the same type of estimating techniques as FIFO taxpayers. Thus, the percentage change obtained in revaluing those inventory layers for which sufficient data is available may be applied to revalue all preceding year's layers.

Example 1

For example, assume a manufacturer produces two different parts. Work-in-process inventory is recorded in terms of equivalent units of finished goods. The manufacturer's specific goods LIFO inventory records show the following at the end of 1985:

Product and layer	*Number*	*Cost*	*LIFO carrying values*
Product #1:			
1983	150	$5.00	$750
1984	100	6.00	600
1985	100	6.50	650
1986	50	7.00	350
			2,350
Product #2:			
1983	200	4.00	800
1984	200	4.50	900
1985	100	5.00	500
1986	100	6.00	600
			2,800
Total of carrying value of Products #1 and #2			5,150

Data available to the taxpayer allows it to revalue the unit costs of product #1 under the new absorption rules to $7.00 in 1984, $7.75 in 1985 and $9.00 in 1986, and to revalue the unit costs of product #2 to $6.00 in 1985 and $7.00 in 1986. The available data for product #1 results in a weighted average percentage change for product #1 of 20.31 percent.[47] The available data for product #2 results in a weighted average percentage change for product #2 of 18.18 percent.[48] The revalued costs for product #1 for 1983 can be estimated by applying the weighted average increase determined for product #1 (20.31 percent) to the unit costs originally carried on the taxpayer's records. The estimated revalued unit cost in the case of product #1 would be $6.02 ($5.00 x 1.2031). The costs of product #2 are redetermined in a similar manner for 1983 and

[47] This is computed as follows: [(100 X (7.00 -6.00)) + (100 X (7.75 -6.50)) + [50 X (9.00 -7.00)] divided by [(100 X 6.00) + (100 X 6.50) + (50 X 7.00)].

[48] This is computed as follows: [(100 X (6.00 -5.00)) + (100 X (7.00 -6.00))] divided by [(100 X 5.00) + (100 X 6.00)].

1984 by applying the weighted average increase determined for product #2 of 18.18 percent to the unit costs of $4.00 and $4.50, yielding revalued unit costs of $4.73 and $5.32 respectively.

The weighted average increase estimation does not affect the revaluation of costs for those years in which actual revaluation is possible. The revalued inventory of the taxpayer would be as follows:

Product and layer	*Number*	*Cost*	*LIFO carrying values*
Product #1:			
1983	150	$6.20	$903
1984	100	7.00	700
1985	100	7.75	775
1986	50	9.00	450
			2,828
Product #2:			
1983	00	4.73	946
1984	00	5.32	1,064
1985	100	6.00	600
1986	100	7.00	700
			3,310
Total of carrying value of Products #1 and #2 under new absorption rules			6,138

The amount of the adjustment (under section 481) is $988 ($6,138 −$5,150).

A taxpayer using the specific goods LIFO method also may have inventories for which new costs have not been incurred for several years and, consequently, a weighted average increase for those particular inventory items may not be available for estimation purposes. In such a case, the taxpayer may take the weighted average increases for all its revalued inventory items and determine an overall percentage increase, weighted by the value of each inventory item included in the calculation, to estimate the revaluation necessary for such items.

The committee anticipates that the Treasury Department will develop rules to permit taxpayers using the dollar-value LIFO method who lack sufficient data to revalue all of their LIFO layers under the new absorption rules to compute the percentage change in the current costs of their inventory as a result of the new absorption rules for the LIFO layers accumulated during the three most recent years that the taxpayer has sufficient information. (These rules will apply to taxpayers acquiring property for resale, as well as taxpayers producing or manufacturing property.) Tax-

payers then would apply that percentage to restate the costs of the beginning LIFO inventory value of the entire pool for the year of change. For purposes of determining future indexes, the year prior to the year of change will then be considered as a new base year and the current costs for that year are to be used for extension purposes to future taxable years. The increase in the beginning balance in the LIFO inventory as a result of this change will represent the section 481 adjustment amount.

Example 2

For example, a calendar year taxpayer first adopted the dollar value LIFO method in 1981, using a single pool and the double extension method. The taxpayer's beginning LIFO inventory for the year of change is as follows:

	Base year costs	*Index*	*LIFO carrying value*
Base layer	$14,000	1.00	$14,000
1981 layer	4,000	1.20	4,800
1982 layer	5,000	1.30	6,500
1983 layer	2,000	1.35	2,700
1984 layer	0	1.40	0
1985 layer	4,000	1.50	6,000
1986 layer	5,000	1.60	8,000
Total	34,000	.....	42,000

The taxpayer is able to recompute inventoriable costs under the new absorption rules for the ending LIFO layers for three preceding taxable years as follows:

Year	*Current cost as recorded*	*Current cost as adjusted*	*Weighted percentage change*
1983	$35,000	$45,150	0.29
1984	43,500	54,375	.25
1985	54,400	70,720	.30
Total	132,900	170,245	.28

Applying the average revaluation factor of .28 to each layer, the inventory is restated as follows:

	Base year costs	*Index*	*LIFO carrying value*
Base layer	$17,920	1.00	$17,920
1981 layer	5,120	1.20	6,144
1982 layer	6,400	1.30	8,320
1983 layer	2,560	1.35	3,456
1984 layer	0	1.40	0
1985 layer	5,120	1.50	7,680
1986 layer	6,400	1.60	10,240
Total	43,520	.....	53,760

The section 481 adjustment is the difference between the revalued LIFO carrying value under the new absorption rules and the LIFO carrying value as originally reported. In this example, the section 481 adjustment is $11,760 ($53,760 −$42,000). The section 481 adjustment also may be found by multiplying the LIFO carrying value as originally reported by the average percentage change determined in first step described above. In this example, that procedure also would determine the amount of the section 481 to be $11,760 ($42,000 X .28).

The year prior to the year of change will be treated as a new base year for the purpose of determining the index in future years. This requires that layers in years prior to the base year be restated in terms of the new base year index. In the example above, the restated inventory would be as follows:

	Restated base year costs	*Index*	*LIFO carrying value*
Old base layer	$28,672	0.625	$17,920
1981 layer	8,192	.75	6,144
1982 layer	10,272	.81	8,320
1983 layer	4,114	.84	3,456
1984 layer	0	.875	0
1985 layer	8,170	.94	7,680
New base layer (1986)	10,240	1.50	10,240
Total	69,660	.....	53,760

For taxpayers not possessing sufficient data to revalue all of their LIFO layers under the new absorption rules, the most recent three years prior to the year of change for which the taxpayer has sufficient information may be used in determining the average revaluation factor. Where the taxpayer possesses sufficient information to use additional years in determining the average revaluation

factor, such additional years may be used at the option of the taxpayer, as long as the additional years are consecutive years prior to the year of change. For example, assume a calendar year taxpayer has sufficient information to revalue years 1981 through 1986. The average revaluation factor may be determined on the basis of all six years. On the other hand, a taxpayer with sufficient information to revalue 1980 through 1982 and 1984 through 1986 would use only the 1982 through 1986 years in determining the average revaluation factor, since the years 1980 through 1982 are not consecutive to the year of change.

The use of the average revaluation factor based upon current costs to estimate the revaluation of older inventory layers may result in an increase in the value of inventories representing costs which did not exist in the affected year. To the extent that a taxpayer can show that costs which contributed to the determination of the average revaluation factor could not have affected a prior year, the average revaluation factor as applied to that year may be adjusted by an appropriate amount.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $4,963 million in 1987, $8,066 million in 1988, $8,266 million in 1989, $7,846 million in 1990, and $7,635 million in 1991.

E. Special Treatment of Certain Items

1. Reserve for Bad Debts (sec. 303 of the bill and sec. 166 of the Code)

Present Law

In general

Present law allows taxpayers a deduction from income for those debts arising from a trade or business which become wholly or partially worthless during the taxable year (sec. 166(a)). The amount of the deduction may be determined using either the specific charge-off method or the reserve method (sec. 166(c)). The deduction is not available to a cash-method lender for items that will be taken into income at the time they are received.

Dealers in property are allowed to establish a reserve for losses which may result from their liability as a guarantor, endorser, or indemnitor on debt which arose as a result of the dealer's sale of real or tangible personal property (sec. 166(f)).

Specific charge-off method

The specific charge-off method allows a deduction for bad debts as the individual debt becomes either wholly or partially worthless. At such time as a receivable is determined to be uncollectible in whole or in part, the receivable is reduced by the amount that is uncollectible, and a deduction is allowed for an equal amount. If an amount previously charged-off as uncollectible is later recovered, the recovery is treated as a separate income item at the time of collection.

Wholly worthless amounts are allowed as a bad debt deduction for tax purposes in the year in which they become worthless. Partially worthless amounts not only must have become partially worthless for Federal income tax purposes, but also must be charged-off on the taxpayer's books in the amount of such partial worthlessness before a bad debt deduction is allowed for Federal income tax purposes. A deduction for partially worthless bad debts is only allowed for business debts.

Reserve method

Under the reserve method, a deduction is allowed for a reasonable addition to a reserve for bad debts. A reserve account is set up as an allowance against the contingency that some receivables may later prove to be uncollectible. The reasonable addition to the reserve for any year is that amount which is necessary to bring the beginning bad debt reserve, adjusted for actual bad debt losses and recoveries during the year, to be increased to the allowed ending balance computed under an approved method. The actual formula is beginning reserve minus actual worthless debts experienced

during the year plus actual recoveries during the year minus deductible addition to reserve equals ending reserve. The formula is solved for the deductible addition after all the other amounts are determined. Thus, amounts charged off or recovered are not items of expense or income, but are integral components of the computation of the deductible addition to the reserve.

The annual addition to the reserve account is required to be reasonable in amount, determined in light of the facts existing at the close of the taxable year of the proposed addition. The most widely used formula for determining the appropriate bad debt reserve for tax purposes is based on the decision in *Black Motor Company* v. *Commissioner*, 41 B.T.A. 300 (1940), aff'd 125 F. 2d 977 (6th Cir. 1941). This formula uses a six year moving average, determined by dividing the sum of bad debts actually charged off (net of actual recoveries) for the most recent six years (including the current year) by the sum of the debts owed the taxpayer over the same six year period. This average is multiplied by the amount of debts outstanding at the close of the current year to produce the reserve balance at the close of the current year. The result is a figure based on past experience which approximates the bad debt charge-offs expected to occur in a single taxable year.

The *Black Motor* formula is not the exclusive method for determining the deductible addition to the reserve. In addition, the result obtained under the formula must still be determined to be reasonable under the circumstances of the year of computation.

Determination of worthlessness

Both the specific charge-off method and the reserve method require a determination of the period in which a debt becomes totally or partially worthless.

Worthlessness is a question of fact, to be determined by considering all pertinent evidence, including the value of any collateral securing the obligation and the financial condition of the debtor. A debt is not worthless merely because its collection is in doubt. As long as there is a reasonable expectation that it eventually may be paid, the debt is not to be considered worthless.

Wholly worthless bad debts may be charged off for Federal income tax purposes only in the year they become worthless, and not in some later year when the fact of worthlessness is confirmed. The period in which the debt is actually charged off the taxpayer's books is not determinative. Partially worthless business bad debts must be charged off on the taxpayer's books in order to be charged off for Federal income tax purposes. However, a charge-off for a partially worthless bad debt for Federal income tax purposes may not be taken after the year in which the debt becomes wholly worthless.

Bad debt reserves for guarantees, etc.

Present law requires that an actual debt be owed to the taxpayer in order to support the creation of a reserve for bad debt losses. For this reason, no deduction is generally allowed for potential losses of taxpayers who guarantee, endorse, or provide indemnity agreements with respect to debts owed to others.

An exception to this general rule is made for dealers in property. To the extent that these types of potential obligations arise from the sale of real or tangible personal property, dealers may establish a reserve account and deduct additions necessary to maintain it in the same manner as a reserve account for business debts owed directly to the taxpayer. This type of reserve normally arises where a guarantee or other indemnification agreement is given to induce a lender to arrange financing for a dealer's property or where a dealer's receivables are factored with rights of recourse.

Reasons for Change

The committee believes that the reserve method of accounting for bad debts should generally be repealed. Use of the reserve method for determining losses from bad debts results in deductions being allowed for Federal income tax purposes for losses that statistically may or may not occur in the future. In this regard, the reserve for bad debts is inconsistent with the treatment of other deductions under the all events test. Moreover, use of the reserve method allows a deduction prior to the time that the losses actually occur. If a deduction is allowed prior to the taxable year in which the loss occurs, the value of the deduction to the taxpayer will be overstated.

The committee believes that the reserve method of accounting for bad debts should continue to be permitted for financial institutions. Financial institutions generally are required by government regulators to maintain capital sufficient to support the level of lending and other activities that they engage in. The committee is concerned that the repeal of the reserve method at this time could jeopardize the ability of financial institutions to meet their capital requirements.

Similarly, the committee recognizes that certain finance companies are important competitors of financial institutions with respect to certain personal and business loans. In order not to provide an unfair competitive advantage to financial institutions, the committee believes that the use of the reserve method of accounting for bad debts also should be continued for these finance companies as well.

Explanation of Provision

In general

The bill repeals the availability of the reserve method of deducting bad debts for all taxpayers, other than financial institutions and certain farm credit institutions and finance companies. The effect of the bill is to require the bad debt expense of all other taxpayers to be recognized using the specific charge-off method.

Taxpayers excepted from the general rule

The bill allows certain taxpayers to continue to use the reserve method of deducting bad debts. Financial institutions who are eligible to compute their bad debt deduction under the provisions of section 585 (relating to banks), section 586 (relating to small business investment companies), and section 593 (relating to thrift in-

stitutions) may continue to compute their deductions using those sections. Certain farm credit institutions also are allowed to continue to use the reserve method. These institutions are production credit associations which are chartered pursuant to section 2091 of Title 12 of the United States Code and banks for cooperatives which are chartered pursuant to section 2121 of title 12 of the United States Code.

The bill provides that finance companies will be allowed to use the reserve method of computing deductions for bad debts with regard to any qualified indebtedness. For the purpose of this provision, a finance company is any person that meets the definition of a lending or finance company contained in section 542(c)(6) and that has as a substantial portion of its business, the making of loans to members of the general public. In determining whether a person meets the definition of a lending or finance company contained in section 542(c)(6), income from a loan that arises from the sale of property or services that were sold or manufactured by the taxpayer (or an affiliate of the taxpayer) is not considered as income derived from the active and regular conduct of a lending or finance business.

A taxpayer is considered to make loans to the general public if it operates offices at which members of the general public may make application for loans. On the other hand, the mere loaning of money by allowing charge purchases on a charge account or credit card would not be the making of loans to members of the general public.

The fact that any specific loan may not be required by the previous arrangement does not result in that loan being considered to be a loan to a member of the general public. Thus, if a person is allowed to charge purchases on a charge account or credit card in excess of the limit previously arranged, the loan arising from the charging of the purchases would still be considered the result of a previous arrangement and not a loan to a member of the general public.

Qualified indebtedness for which a finance company may use the reserve method of computing its losses from bad debts is all indebtedness originated by the taxpayer other than (i) loans arising from the sale of property or services that were sold or manufactured by the taxpayer or an affiliate of the taxpayer and (ii) negotiable instruments and notes. A loan will be considered as having been originated by the taxpayer if it is acquired by the taxpayer pursuant to a prior arrangement with the person originating the loan. An entity meeting the definition of a finance company may use the reserve method of computing bad debts only with regard to qualifying indebtedness. The bad debt expense on debts that are not qualifying indebtedness must be recognized using the specific charge-off method.

Booking requirement

The bill conforms the treatment of wholly worthless business debts to the treatment of partially worthless business debts by providing that no business debt will be deductible as wholly or partially worthless for Federal income tax purposes until it is charged off on the taxpayer's books. Thus, no deduction for a worthless busi-

ness debt is allowed prior to the time it is so recognized for other purposes.

This change resolves a potential difficulty which can arise under present law where a taxpayer does not discover that the debt is worthless until a later year. The rules of present law require that the taxpayer amend a prior year's return in order to obtain the deduction. The year of actual worthlessness may be a closed taxable year. The bill avoids this problem by requiring the debt to be both worthless and charged-off before a deduction is allowed. Thus, the taxpayer cannot be required to deduct the bad debt in a year prior to the year in which he discovers it to be worthless.

In adopting this change, the committee does not intend to create an opportunity for taxpayers to assign deductions for worthless debts to whichever taxable year will yield the lowest overall tax burden. Thus, where it is clearly demonstrable that a taxpayer is actually aware that a debt is wholly worthless, the committee intends that the deduction be allowable in the year that the taxpayer becomes aware of the bad debt, even if the taxpayer delays charging it off his books in order to avoid tax liability.

Bad debt reserves for guarantees, etc.

The bill also repeals the reserve method for dealers who guarantee, endorse or provide indemnity agreements with respect to debts owed to others. Expenses that arise from a dealer's guarantee, endorsement, or indemnity agreement are not deductible until the dealer suffers a loss as a result of its honoring the guarantee, endorsement or indemnity agreement. If the dealer is subrogated to the rights of the original creditor, such loss will be deductible at the time the subrogation rights become wholly or partially worthless and the dealer charges off the amount on its books.

Transitional rules

The bill treats any change from the reserve method to the specific charge-off method as a result of the bill as a change in the taxpayer's method of accounting, initiated by the taxpayer with the consent of the Secretary of the Treasury. To prevent taxpayers from deducting losses on debts twice, first as a deduction to a reserve for bad debts under current law and later as a deduction due to the debt being specifically charged off after the required change in accounting method, the bill requires that the balance in any reserve for bad debts as of the effective date be taken into income ratably over a five-year period. In the case of a bad debt reserve for guarantees, the amount of the reserve is first reduced by the balance in any suspense account established under section 166(f)(4) and the net amount taken into income ratably over a five-year period.

Effective Date

The provision is effective for taxable years beginning after December 31, 1986.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $873 million in 1987, $1,380 million in 1988, $1,314 million in 1989, $1,326 million in 1990, and $1,327 million in 1991.

2. Qualified Discount Coupons (sec. 324 of the bill and sec. 466 of the Code)

Present Law

Under present law, issuers of qualified discount coupons using the accrual method of accounting may elect to deduct the cost of redeeming qualified discount coupons outstanding at the close of the taxable year and received for redemption by the taxpayer within a statutory redemption period following the close of the taxable year (sec. 466). The statutory redemption period is the 6-month period immediately following the close of the taxable year, unless the taxpayer elects a shorter period.

A qualified discount coupon is coupon which (1) is issued by the taxpayer, (2) is redeemable by the taxpayer, and (3) allows a discount on the purchase price of merchandise or other tangible personal property. The coupon must not be redeemable directly by the issuer (i.e., a direct consumer rebate) and may not by itself, or in conjunction with any other coupons, bring about a price reduction of more than $5 with respect to any item.

The election must be made with respect to each trade or business of the taxpayer and constitutes a method of accounting. Revocation of an election may be made only with permission of the Secretary of the Treasury. In certain situations, a taxpayer is required to establish a suspense account in the year of election in order to limit the bunching of deductions in that year.

Reasons for Change

The committee believes that the provision of current law allowing a deduction for discount coupons received for redemption after the close of the taxable year results in an incorrect measurement of taxable income. A coupon received during the redemption period is deductible in computing the prior year's income even though it may relate to the sale of a product which took place during the current taxable year and such a mismatch may occur even though the coupon was outstanding at the end of the prior taxable year. Thus, a deduction may be allowed in the year prior to the year in which the income is recognized.

The committee also believes that the present law provision provides an unwarranted exception to the general rules of tax accounting. An accrual basis taxpayer normally is allowed to recognize an expense only when all events establishing its obligation to pay the amount claimed as a deduction have occurred, the amount thereof can be determined with reasonable accuracy, and there has been economic performance with respect to the item. Absent the special provision of present law for discount coupons, such costs would not be considered deductible until the coupons actually were redeemed.

Explanation of Provision

The bill repeals the provision of present law allowing a deduction for the cost of redeeming qualified discount coupons received during a redemption period after the close of the taxable year. As a result, only those costs of redeeming discount coupons received for redemption during the taxable year will be allowed as a deduction during that taxable year.

The bill treats any taxpayer currently electing to deduct the cost of redeeming qualified discount coupons as having elected to change its method of accounting. The change will be considered to have been initiated by the taxpayer with the consent of the Secretary of the Treasury. Any adjustment which is required to be made by section 481 will be reduced by any balance in the suspense account of the taxpayer, and the net amount is to be taken into account ratably over a period not to exceed five taxable years, commencing with the first taxable year beginning after December 31, 1986. It is expected that the concepts of Revenue Procedure 84–74, 1984-2 C.B. 736, generally will apply to determine the actual timing of recognition or expense as a result of the adjustments arising from this provision.

Effective Date

The provision is effective for taxable years beginning after December 31, 1986.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $13 million in 1987, $25 million in 1988, $28 million in 1989, $29 million in 1990, and $30 million in 1991.

3. Depreciation Recapture Income on Installment Sales of Farm Irrigation Equipment (sec. 313 of the bill and sec. 453(i) of the Code)

Present Law

In an installment sale of depreciable real or personal property, all depreciation recapture income under sections 1245 and 1250 is recognized in the taxable year of the disposition, whether or not principal payments are received in that year. Any gain in excess of the depreciation recapture income is taken into account under the installment method (sec. 453).

Reasons for Change

Prior to the Deficit Reduction Act of 1984, any depreciation recapture income was recognized only as (and to the extent) gain was required to be reported under the installment method for the taxable year. The committee understands that the changes made to the installment provisions by the Deficit Reduction Act may have proved unduly burdensome for some farmers, many of whom have been forced by the current farm crisis to sell their irrigation equipment on the installment method. In many cases, the selling farmer lacks the funds to pay the tax that will result from full recapture

of depreciation in the year of sale. The committee believes that it is appropriate to provide relief from the normal rules in this situation.

Explanation of Provision

The bill provides that depreciation recapture income resulting from an installment sale of equipment used to irrigate farmland is recognized under the rules in effect prior to the Deficit Reduction Act. Accordingly, any depreciation recapture with respect to such equipment will be recognized as gain is recognized under the installment method.

Effective Date

The provision is effective as if included in the Deficit Reduction Act of 1984.

Revenue Effect

This provision is estimated to decrease fiscal year budget receipts by less than $5 million annually.

F. Cancellation of Indebtedness for Solvent Taxpayers (sec. 323 of the bill and sec. 108 of the Code)

Present Law

Present law provides that gross income includes "income from discharge of indebtedness" (sec. 61(a)(12)). A discharge of indebtedness is considered to occur whenever a taxpayer's debt is forgiven, cancelled, or otherwise discharged by a payment of less than the principal amount of the debt. The amount of indebtedness discharged is equal to the difference between the face amount of the debt, adjusted for any unamortized premium or discount, and any consideration given by the taxpayer to effect the discharge.

Exceptions to the general rule are provided in cases where the discharge occurs in a case arising under title 11 of the United States Code (relating to bankruptcy), when the taxpayer is insolvent, or where the indebtedness discharged is qualified business indebtedness (sec. 108(a)(1)). Qualified business indebtedness is indebtedness incurred or assumed by a corporation or by an individual in connection with property used in the individual's trade or business. A taxpayer must elect to have the indebtedness treated as qualified business indebtedness (sec. 108(d)(4)).

In the case of a discharge of qualified business indebtedness, the amount of the discharge that would have been included in gross income had the discharge not been of qualified business indebtedness is applied to reduce the basis of depreciable property of the taxpayer (sec. 108(c)(1)). An election is available to treat inventory as depreciable property for this purpose. The amount of discharge income that can be excluded as a discharge of qualified business indebtedness is limited to the basis of the taxpayer's depreciable property. If the amount of discharge income exceeds the basis of depreciable property, the excess is included in gross income for the year in which the discharge occurs.

Reasons for Change

The committee is concerned that the present law treatment of discharges of qualified business indebtedness is too generous. Income from such discharges generally is deferred by reducing the basis of depreciable assets, regardless of the capacity of the taxpayer to currently pay the tax. In addition, the provision produces disparate results among taxpayers depending upon the makeup of their depreciable assets. For taxpayers without sufficient amounts of inventory or depreciable assets, the full benefit of the deferral is not available.

Explanation of Provision

The bill repeals the provision of present law (sec. 108(a)(1)(C)) which provides for the exclusion from gross income of income from the discharge of qualified business indebtedness. The effect of the bill is to require that any discharge of indebtedness, other than a discharge in title 11 cases and a discharge that occurs when the taxpayer is insolvent, results in the current recognition of income in the amount of the discharge.

The committee does not intend to change the present law treatment of a discharge of indebtedness that occurs in a title 11 case or when the taxpayer is insolvent.[49] The committee also does not intend to change the provision of present law (sec. 108(e)(5)) that treats any reduction of purchase-money debt of a solvent debtor as a purchase price adjustment, rather than a discharge of indebtedness.

Effective Date

The provision is applicable to discharges of indebtedness occurring after December 31, 1986.

Revenue Effect

The provison is estimated to increase fiscal year budget receipts by $59 million in 1987, $83 million in 1988, $65 million in 1989, $55 million in 1990, and $45 million in 1991.

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[49] Sec. 706 of the bill provides that certain solvent farmers will be treated aas insolvent taxpayers for the purpose of determining whether there is income from the discharge of indebtedness. To the extent that a farmer is considered insolvent under sec. 706 of the bill, no income will be required to be recognized under this provision.

G. Taxable Year of Partnerships, S Corporations, and Personal Service Corporations (sec. 304 of the bill and secs. 441, 706, and 1378 of the Code)

Present Law

In general

Taxable income is computed on the basis of a taxpayer's taxable year. A taxpayer's taxable year generally is required to be the same as the taxpayer's annual accounting period, i.e., the twelve-month period on the basis of which the taxpayer regularly computes his income in keeping his books. A taxable year that ends on the same day of the week in each year (a 52-53 week year) also is acceptable. Taxpayers generally are allowed to select any taxable year on their first Federal income tax return that is consistent with their annual accounting period. The taxable year for most individuals is the calendar year. Certain types of entities, including partnerships and S corporations, are required to select taxable years that generally conform to the taxable years of their owners. Once a taxable year is selected, the permission of the Secretary of the Treasury is required for any change.

Partnerships

Under present law, partners in a partnership take into account their allocable share of income, gain, loss, deduction or credit of the partnership for their taxable year in which the partnership's taxable year ends. The items of income, gain, loss, deduction or credit are computed at the partnership level and reflect the partnership's (not the partner's) taxable year. To the extent that the partner's and the partnership's taxable years are not the same, a deferral of income can result. For example, assume a partnership has a taxable year ending in June, while an individual partner has a calendar year. The partner will include in his income tax return for the current calendar year his distributive share of partnership items that arose in the first six months of the current calendar year and his share of such items that arose in the last six months of the prior calendar year. Partnership items arising in the last six months of the current calendar year will not be included in the partner's return until the following calendar year. Thus, the recognition of six months' of partnership income has been deferred by the partner until the following taxable year.

Present law requires a partnership adopting or changing a taxable year to use the year of all of its principal partners (or the calendar year, if all of the partnership's principal partners do not have the same taxable year), unless the partnership establishes to the satisfaction of the Secretary of the Treasury a business purpose for selecting a different taxable year (sec. 706). A principal partner

is a partner having an interest of five percent or more in partnership profits or capital. A partnership that adopted its taxable year prior to April 2, 1954, is not required to change its taxable year regardless of whether or not the taxable year adopted is the same as the taxable year of all of the partnership's principal partners. (Treas. Regs. sec. 1.706-1(b)(6))

In 1972, the Internal Revenue Service issued Revenue Procedure 72-51 (1972-2 C.B. 832), announcing the procedures to be followed in approving a request by a partnership desiring to change to, or to adopt, a taxable year other than that of all of its principal partners. The Revenue Procedure provides that consideration will be given to all the facts and circumstances, including any distortion of income due to the deferral of income, in determining whether a taxable year different from that of all the principal partners is acceptable. However, in order to facilitate adoptions or changes with a minimum of distortion, requests by a partnership to adopt or change to an accounting period differing from that of the principal partners will generally be approved where the adoption of such change would result in the deferral of income to the partners of three months or less. Under the Revenue Procedure, if a taxpayer adopts a taxable year providing 3 months or less deferral of income, the taxpayer is required to add a certain amount of income to the short period required to effect the change of taxable year. The taxpayer is then allowed to deduct this amount ratably over a ten year period beginning with the year of change.

S corporations

Under present law, shareholders of an S corporation take into account undistributed taxable income and net operating losses of the S corporation for their taxable year in which the S corporation's taxable year ends. To the extent that a taxable year of a shareholder and an S corporation are not the same, a deferral of tax can result that is similar to the deferral present with respect to partnerships, as discussed above.

Present law requires a corporation that makes an election to be taxed as an S corporation, or an S corporation that changes its taxable year, to adopt a "permitted year" (sec. 1378). A permitted year is a calendar year or any other accounting period for which the S corporation establishes a business purpose to the satisfaction of the Secretary of the Treasury. A corporation that was an S corporation for a taxable year that includes December 31, 1982 (or that was an S corporation for a taxable year beginning in 1983 by reason of an election made on or before October 19, 1982) may retain a taxable year that is not a permitted year. However, if more than 50 percent of the stock of such an S corporation is newly owned stock, the S corporation must change its taxable year to a permitted year. Revenue Procedure 83-25 (1983-1 C.B. 689) provides procedures similar to those in Revenue Procedure 72-51 (supra) that the Internal Revenue Service will follow in approving a request by an S corporation desiring to change to, or to adopt, a taxable year other than a calendar year.

Personal service corporations

Under present law, personal service corporations generally are taxed in the same manner as other corporations. A personal service corporation generally may adopt any taxable year on its first Federal income tax return that conforms with its annual accounting period. A personal service corporation desiring to change its taxable year must first obtain the consent of the Secretary of the Treasury.

A personal service company normally reports its income and pays tax only at the corporate level. However, a deferral similar to the deferrals available for partnerships and S corporations may be accomplished through the use of the personal service corporation. For example, assume a personal service corporation with a taxable year ending in January pays its calendar year employee-owners a minimal salary during the year and, immediately prior to the close of the corporation's taxable year (during January), declares a bonus to the employee-owners equal to the profits of the corporation. The corporation obtains a deduction for the bonus paid and the employee-owners need not report the bonus income until the following December, when the employee-owners' calendar years end. Thus, the tax on the bonus is effectively deferred.

Current law provides special rules for a personal service corporation substantially all the services of which are performed for or on behalf of one other entity, and which is formed or availed of to avoid or evade tax. The Secretary of the Treasury is empowered to allocate all income, deductions, credits, exclusions and other allowances between this type of personal service corporation and its employee-owners, if such allocation is necessary to prevent the avoidance or evasion of Federal income tax or to reflect clearly the income of the personal service corporation or any of its employee-owners (sec. 269A). This rule does not apply in the case where the personal services of the corporation are performed on behalf of more than one other entity, such as a professional corporation with more than one employee-owner.

Reasons for Change

The committee believes that present law allows an improper deferral of income for certain partners, shareholders in S corporations, and owners of personal service corporations. Older partnerships, partnerships where the taxable year of the principal partners is not representative of the taxable year of the majority partners, older S corporations, and personal service corporations, are allowed taxable years that make such deferral possible, while other partnerships and S corporations are required to use taxable years conforming more closely to the taxable years of their owners. The committee believes that this feature of present law decreases the fairness of the Internal Revenue Code and provides an unwarranted competitive advantage to certain taxpayers.

Explanation of Provision

The bill requires that all partnerships, S corporations, and personal service corporations conform their taxable years to the tax-

able years of their owners. The bill provides that a partnership may not have a taxable year other than the taxable year of its partners owning a majority interest in partnership profits and capital, unless it establishes to the satisfaction of the Secretary of the Treasury a business purpose therefor. If partners owning a majority of partnership profits and capital do not have the same taxable year, the partnership must adopt the same taxable year as its principal partners. If the principal partners of the partnership do not have the same taxable year and no majority of its partners have the same taxable year, the partnership must adopt a calendar year as its taxable year.

For example, assume a partnership has one principal partner which is a fiscal year corporation owning an interest of 10 percent in partnership profits and capital. The remainder of the partners are individuals on a calendar taxable year; none of these individuals owns a sufficient interest in the partnership to be a principal partner. Under present law, the partnership would be required to adopt the same taxable year of the corporate partner (i.e., the taxable year of its principal partner). However, under the bill, the partnership would be required to adopt a calendar taxable year (i.e., the taxable year of the majority of its partners).

An S corporation must adopt a permitted year, regardless of when the corporation elected to be taxed as an S corporation. Also, the bill requires that a personal service corporation must adopt a calendar year.

An exception is provided in each case where the partnership, S corporation, or personal service corporation establishes to the satisfaction of the Secretary of the Treasury a business purpose for having a different taxable year. It is anticipated that present administrative practice which generally allows, under certain conditions, the use of a taxable year resulting in 3 months or less deferral will apply for purposes of this provision.

A partnership is not required to adopt the taxable year of the partners owning a majority interest in partnership profits and capital, unless partners with the same taxable year have owned a majority interest in partnership profits and capital for the three preceding taxable years of the partnership. For purposes of determing whether this three-year test has been met, taxable years of the partnership beginning before the effective date of the bill are taken into account. Thus, for example, assume a fiscal year partnership had a taxable year other than the taxable year of its partners owning a majority interest in partnership profits and capital, for the partnership's taxable years ending in 1985, 1986, and 1987. For the partnership's taxable year beginning in 1987, the partnership would be required to change its taxable year to conform with the taxable year of the partners owning a majority interest in partnership profits and capital.

The bill provides that a partnership, S corporation, or personal service corporation that changes to a taxable year required by this provision will be treated as having made the change with the consent of the Secretary of the Treasury. In the case of a partnership or an S corporation, each partner or owner may elect to take the excess of income over expense for any short taxable year that results from the change in the taxable year into account ratably over

the first four taxable years (including the owner's year which would otherwise include the income or loss of the entity's short taxable year) beginning after December 31, 1986. Absent such an election, the amount of net income or loss for the short taxable year is currently included, in its entirety, by the owner. In the case of a personal service corporation, the short taxable year resulting from the change of taxable year is annualized under section 443.

A partnership, S corporation, or personal service corporation seeking to use a taxable year other than the taxable year required by this provision must obtain the consent of the Secretary of the Treasury. It is expected that the concepts embodied in the current Revenue Procedures dealing with the taxable years of partnerships (Rev. Proc. 72-51, 1972-2 C.B. 832) and of S corporations (Rev. Proc. 83-25, 1983-1 C.B. 689) will be followed to the extent they do not conflict with this provision. It is anticipated that entities having previously established to the satisfaction of the Secretary of the Treasury (in accordance with the terms of those Revenue Procedures) a sufficient business purpose for using a different taxable year will not be required to obtain the Secretary of the Treasury's permission in order to keep such taxable year.

For purposes of this provision, a personal service corporation is a corporation the principal activity of which is the performance of personal service if services are substantially performed by employee-owners. An employee-owner is any employee of the corporation who owns, on any day during the taxable year, any of the outstanding stock of the corporation. In determining whether an employee owns stock in the corporation, the constructive ownership rules of section 318 apply, except that the attribution of stock owned by a corporation to the employee is applied without regard to any requirement that the employee own a certain percentage of the value of the stock of that corporation. For the purpose of this provision, a corporation that has elected S corporation status will not be considered a personal service corporation.

Effective Date

The provision is effective for taxable years beginning after December 31, 1986. Entities required to change their taxable years as a result of this provision will be required to file a return for the short taxable year that begins with the first day of their current taxable year beginning after December 31, 1986, and ends in accordance with the taxable year to which the entity changes.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $70 million in 1987, $200 million in 1988, $200 million in 1989, $165 million in 1990, and $90 million in 1991.

IV. CAPITAL GAINS AND LOSSES

A. Individual Capital Gains and Losses (secs. 401 and 402 of the bill and sec. 1202 of the Code)

Present Law

Individual and other noncorporate taxpayers may deduct from gross income 60 percent of the amount of any net capital gain for the taxable year, i.e., 60 percent of the excess of net long-term capital gain over net short-term capital loss. As a result, the highest tax rate applicable to a noncorporate taxpayer's net capital gain is 20 percent (the 50-percent maximum individual tax rate times the 40 percent of net capital gain included in adjusted gross income).

Capital losses of individuals are deductible in full against capital gains. In addition, a maximum of $3,000 of capital losses are deductible against ordinary income. However, only 50 percent of net long-term capital losses in excess of net short-term capital gains may be deducted from ordinary income.

Reasons for Change

The committee believes that as a result of the bill's reduction of individual tax rates on such forms of capital income as business profits, interest, dividends, and short-term capital gains, the need to provide a reduced rate for net capital gain is eliminated. This will result in a tremendous amount of simplification for many taxpayers since their tax will no longer depend upon the characterization of income as ordinary or capital gain. In addition, this will eliminate any requirement that capital assets be held by the taxpayer for any extended period of time (currently 6 months) in order to obtain favorable treatment. This will result in greater willingness to invest in assets that are freely traded (e.g., stocks).

The committee believes that the top rate on individual capital gains should not exceed the rates set forth in the bill, and therefore the bill provides that the maximum tax rate on capital gains will not exceed the top individual rate that the bill presently provides even if the top individual rate is increased during subsequent consideration of the bill.

Explanation of Provision

The bill repeals the net capital gain deduction for individuals.[1]

The bill also provides that the tax imposed by section 1 on an individual, estate, or trust cannot exceed the sum of (1) a tax computed at the rates under section 1 on the greater of (a) the taxpayer's taxable income reduced by the amount of net capital gain or

[1] The minimum tax is conformed by deleting the capital gain preference.

(b) the amount of the taxpayer's taxable income which is taxed at a rate below 27 percent; (2) a tax of 27 percent on the amount of the taxpayer's taxable income in excess of the amount determined under (1) above; and (3) any additional tax resulting from the gradual phaseout of the benefits of the 15-percent bracket. If for any taxable year, the highest individual rates (under the tax rate schedules set forth in sec. 1(a)) do not exceed 27 percent, then this limitation will have no application.

The result of these provisions is that capital gains (including all capital gains recognized during calendar year 1987) will not be taxed at rates exceeding the top individual rates that become effective on July 1, under the committee bill.

A conforming amendment is made to allow losses from the sale or exchange of capital assets to the extent of gains from the sale or exchange of capital assets plus $3,000.

The bill does not change the character of gain as capital or ordinary.

Effective Date

This provision applies to taxable years beginning after December 31, 1986.

Revenue Effect

The revenue effect of this provision is included with the revenue effect for individual rate changes.

B. Incentive Stock Options (sec. 411 of the bill and sec. 422A of the Code)

Present Law

An employee is not taxed on the grant or exercise of an incentive stock options and the employee is generally taxed at capital gains rates when the stock received on the exercise of the option is sold. No deduction is taken by the employer when the option is granted or exercised.

In order to qualify as an incentive stock option, among other requirements, the options must be exercisable in the order granted and the employer may not grant the employee such options to acquire stock with a value of more than $100,000 (increased by certain carryover amounts) in any one year.

Reasons for Change

The committee wishes to eliminate certain restrictions on incentive stock options so that it will be easier for employers, particularly small and relatively new companies, to use the options as a means of attracting and motivating talented employees.

The rule requiring options to be exercisable only in the order granted can make incentive stock options unavailable to companies which have experienced a decline in stock prices.

The committee believes that limiting the amount of incentive stock options an employer may grant to an employee in a year unnecessarily restricts the ability of smaller companies to offer a comprehensive compensation package which it may need to offer talented employees if it is to compete with larger, more established corporations for such employees.

Explanation of Provision

The bill repeals the requirement that incentive stock options must be exercisable in the order granted.

The bill also changes the $100,000 limit to provide that the aggregate fair market (determined at the time the option is granted) of the stock with respect to which incentive stock options are exercisable for the first time under the terms of the plan by any employee during any calendar year may not exceed $100,000.

Effective Date

The provision applies to options granted after December 31, 1986.

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by less than $5 million annually.

C. Tax Straddles (secs. 421 and 422 of the bill and secs. 1092 and 1256 of the Code)

Present Law

Loss deferral rule

In general, if a taxpayer realizes a loss on the disposition of one or more positions in a straddle, the amount of the loss that can be deducted is limited to the excess of the loss over the unrecognized gain (if any) in offsetting positions (sec. 1092). An exception to the loss deferral rule applies to a straddle consisting of stock that is offset by a qualified covered call. For purposes of this exception, a call option is not treated as qualified if gain from the disposition of the underlying stock is included in gross income in a taxable year subsequent to the year in which the option is closed, and the stock is not held for more than 30 days following the date on which the option is closed. This rule is intended to prevent taxpayers from using covered call options to defer tax on income from unrelated transactions (by realizing a loss on the option in one year, and deferring realizing any gain on the related stock until the next year).

Treatment of gains and losses on section 1256 contracts

A section 1256 contract (e.g., a regulated futures contract or a nonequity listed option) held by a taxpayer at year-end is treated as if it were sold for its fair market value on the last business day of the year. Any gain or loss on a section 1256 contract is treated as if 40 percent were short-term capital gain or loss, and as if 60 percent were long-term gain or loss. This allocation of capital gain results in a maximum rate of tax of 32 percent for investors other than corporations.

Reasons for Change

Under present law, the exception to the loss deferral rule for qualified covered call options applies even where the straddle is used to defer tax on income from unrelated transactions. Such deferral may occur where gain from closing the option is included in gross income in a taxable year subsequent to the year in which the stock is disposed of at a loss. The bill amends the definition of a qualified covered call to exclude a covered call option in these circumstances.

The committee bill lowers the maximum rate of tax on capital gain (long- or short-term) to 27 percent for investors other than corporations. This rate reduction obviates the need for a special capital gain tax rate for section 1256 contracts.

Explanation of Provisions

Qualified covered call options

Under the bill, the qualified covered call exception to the loss deferral rule is denied to a taxpayer who fails to hold a covered call option for 30 days after the related stock is disposed of at a loss, where gain on the option is included in the subsequent year.

Section 1256 gain or loss

The bill amends section 1256 to require gain or loss on section 1256 contracts to be treated as short-term capital gain or loss. Conforming changes are made to the provision that permits taxpayers to carry back losses from section 1256 contracts.

Effective Dates

The amendments to the definition of a qualified covered call and to section 1256 apply to positions established after December 31, 1986.

Revenue Effect

The revenue effects of these provisions are included with the revenue effects for individual and corporate rate changes.

TITLE V. COMPLIANCE AND TAX ADMINISTRATION

A. Penalties

1. Penalties for Failure to File Information Returns or Statements (Sec. 501 of the bill and secs. 6652, 6676, and 6678, and new secs. 6721, 6722, 6723, and 6724 of the Code)

Present Law

The Code requires that information returns be filed with the IRS, and a copy be given to the taxpayer, detailing all wages, most other types of income, and some deductions. These requirements apply to a variety of specific payments, and are described in a number of Code provisions.

The Code also provides civil penalties for failure either to file an information return with the IRS (sec. 6652) or to provide a copy to the taxpayer (sec. 6678). The general penalty for failure to supply an information return to the IRS is separate from the penalty for failure to give a copy to the taxpayer. Generally, these penalties are $50 for each failure; the maximum penalty under each provision is $50,000 per year.

The Code also provides a penalty of either $5 or $50 (depending on the nature of the failure) for failure to furnish a correct taxpayer identification number (for individuals, the social security number) (sec. 6676). The Code does not provide a penalty for including other incorrect information on an information return.

Reasons for Change

The committee believes that simplifying these penalties, consolidating them, and making them more comprehensible will have a beneficial impact on tax compliance. Taxpayers will be able to understand more easily the consequences of noncompliance, and the administration of these penalties by the IRS should be facilitated by this simplification and consolidation.

The committee also believes that persons required to file these information returns (and provide the copies for taxpayers) who include incorrect information on them should be subject to a penalty.

The committee is concerned that the current maximum of $50,000 for each of these penalties may diminish the efficacy of these penalties in instances where there has been a massive failure to file these information returns. The committee is also concerned, however, that total elimination of these maximum amounts could subject taxpayers to enormous potential liability that would be disproportionate both to the taxpayer's culpability and to the penalties for many other Federal offenses. Consequently, the committee has preserved a maximum amount for each of these penalties, but has also raised the dollar amounts of those maximums.

Explanation of Provision

The bill consolidates the penalty for failure to file an information return with the IRS with the penalty for failure to supply a copy of that information return to the taxpayer in the same subchapter of the Code. The general level of each of these penalties remains at $50 for each failure. The maximum penalty is raised from $50,000 to $100,000 for each category of failure.[1] Thus, a maximum penalty of $100,000 applies to failure to file information returns with the IRS, and another maximum penalty of $100,000 applies to failure to supply copies of information returns to taxpayers.

As under present law, the bill imposes these penalties without limits where the failure to file information returns with the IRS is due to intentional disregard of the filing requirement. The bill also provides, as does present law, generally higher penalties for each failure to file where the failure to file is due to intentional disregard. The bill modifies the levels of these higher penalties for certain specified failures. Thus, the penalty for failure to report cash transactions that exceed $10,000 [2] is increased to 10 percent of the amount that should have been reported. Also, the penalty for failure to report exchanges of certain partnership interests [3] or failure to report certain dispositions of donated property [4] is 5 percent of the amount that should have been reported.

These provisions have generally been redrafted to improve their comprehensibility and administrability. In light of this redrafting, the bill repeals the existing penalty for failure to furnish an information return to the IRS (sec. 6652(a)) and the existing penalty for failure to supply a copy of the information return to the taxpayer (sec. 6678).

The bill also adds to the Code a new penalty for failure to include correct information either on an information return filed with the IRS or on the copy of that information return supplied to the taxpayer. This new penalty applies to both an omission of information or an inclusion of incorrect information. The amount of the penalty is $5 for each information return or copy for the taxpayer, up to a maximum of $20,000 in any calendar year. This maximum does not apply in cases of intentional disregard of the requirement to file accurate information returns.

This new penalty does not apply to an information return if a penalty for failure to supply a correct taxpayer identification number has been imposed with respect to that information return. Thus, if the person filing an information return is subject to a penalty under section 6676 for including an incorrect social security number on the information return, this new penalty is not imposed with respect to that information return.

This new penalty is intended to provide to persons filing information returns an incentive both to file accurate and complete information returns initially and to correct as rapidly as possible any

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[1] The bill also raises from $50,000 to $100,000 the maximum penalty for failure to supply taxpayer identification numbers (sec. 6676).
[2] See Code sec. 6050I.
[3] See Code sec. 6050K.
[4] See Code sec. 6050L.

incorrect information returns that may have been filed. If a person files what purports to be an information return, but which contains so many inaccuracies or omissions that the utility of the document is minimized or eliminated, the IRS may under circumstances such as these (as it does under present law) impose the penalty for failure to file an information return, rather than this new penalty for filing an information return that includes inaccurate or incomplete information. If the IRS imposes a penalty for failure to file an information return, it may not in addition impose a penalty for filing an incorrect information return with respect to the same information.

As under present law, there is an exception from all of these penalties if the failure to file an information return with the IRS or to provide a copy to the taxpayer or to include correct information on either of those returns is due to reasonable cause and not to willful neglect. Thus, under this standard, if a person required to file fails to do so because of negligence or without reasonable cause, that person would be subject to these penalties. The bill retains the higher standards and special rules of present law that apply to failures with respect to interest or dividend returns or statements.

The bill also clarifies the provisions relating to furnishing a written statement to the taxpayer of a number of the substantive information reporting provisions of the Code. Under present law, a number of these provisions arguably may be technically effective only if the person required to supply the copy to the taxpayer has actually provided the information return to the IRS. These provisions have been redrafted so that the requirement to supply a copy of the information return to the taxpayer is triggered when there is an obligation to file (instead of the actual filing of) an information return with the IRS.

Effective Date

The provision is effective for information returns the due date of which (determined without regard to extensions) is after December 31, 1986.

2. Increase in Penalty for Failure to Pay Tax (Sec. 502 of the bill and sec. 6651 of the Code)

Present Law

The Code provides that a taxpayer who fails to pay taxes when due must pay a penalty (sec. 6651(a)(2) and (3)). The penalty applies to a taxpayer who fails to pay taxes shown on the tax return. It also applies to a taxpayer who fails to pay taxes not shown on the tax return within 10 days of notice and demand for payment by the IRS. The penalty is one-half of one percent of the tax for the first month not paid, and increases by one-half of one percent for each month the failure to pay continues, up to a maximum of 25 percent.

This penalty can be abated if the failure is due to reasonable cause and not willful neglect. This penalty is not deductible for tax purposes.

Reasons for Change

The committee agrees with the President's proposal that it is appropriate that taxpayers who delay payment of properly owed taxes should pay penalties approximately equal to the overall cost of collecting these delinquent taxes. Thus, the cost of collecting these delinquent taxes would in effect be borne by those who have delayed making payment, rather than by all taxpayers.

The committee has maintained the general structure of the present law penalty for failure to pay taxes, but has increased the amount of the penalty once the IRS generally initiates more expensive collection methods. The committee also requires a report from the Treasury describing its proposed cost of collection charge system, under which a taxpayer would be required to pay for the specific costs of the specific IRS actions required to collect the delinquent taxes from that taxpayer.

Explanation of Provisions

Modification of penalty

The bill modifies the penalty for failure to pay taxes that exists in present law by increasing in specified situations the amount of that penalty from one-half of one percent per month to one percent per month.[5] This increase occurs after the IRS notifies the taxpayer that the IRS will levy upon the assets of the taxpayer. The IRS can do this in either of two ways. The most common method is that the IRS sends to the taxpayer a notice of intention to levy; this notice must be sent out at least 10 days before the levy occurs (sec. 6331(d)). In these circumstances, the increase in the penalty occurs at the start of the month following the month in which the 10-day period expires. The second method may be used when the IRS finds that the collection of the tax is in jeopardy. If this occurs, the IRS may make notice and demand for immediate payment of the tax, and, if the tax is not paid, the IRS may levy upon the assets of the taxpayer without regard to the 10-day requirement (sec. 6331(a)). Under this second method, the IRS makes notice and demand for immediate payment either in person or by mail. In these circumstances, the increase in the penalty occurs at the start of the month following the month in which notice and demand is made.

This increase in the rate of this penalty generally will occur after the IRS has made repeated efforts to contact the taxpayer by mail.[6] During the period that these initial mailings are made, the penalty for failure to pay taxes will remain at one-half of one percent. When the cycle of mailings is completed and the tax has not yet been paid, the IRS must switch to methods of collecting the tax that generally are much more expensive, such as telephoning or visiting the taxpayer. This is the point at which generally the penalty increases to one percent per month.

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[5] Once the penalty rate in effect is one percent for any month with respect to a particular taxable year and type of tax, the one-percent rate is applicable to any penalty for failure to pay taxes for that taxpayer for all such months.

[6] Generally, the IRS sends taxpayers a series of four or five letters demanding payment before a levy is made. These letters will go out over a period of approximately six months. The IRS will, however, truncate the number of letters and the time between them for reasons such as concern that delay will jeopardize collection.

The bill also improves the coordination of the penalty for failure to pay taxes with the penalty for failure to file a tax return. Under present law, a taxpayer who does not file his tax return on time may be liable for a smaller total penalty (consisting of both the failure to file penalty and the failure to pay penalty) if the taxpayer never files a return than if the taxpayer files the return late. This occurs because the special rules of section 6651(c)(1)(B) in effect reduce the failure to pay penalty by the failure to file penalty. The committee views this result as anomalous and, accordingly, repeals this special offset rule.

Treasury report on cost of collection change

The bill requires the Treasury Department to report to the Senate Committee on Finance and the House Committee on Ways and Means by March 1, 1987, with specific recommendations as to how the cost of collection charge described in the President's proposal would be implemented.

Effective Date

The increase in the penalty for failure to pay taxes (as well as the repeal of the special coordination rule of section 6651(c)(1)(B)) is effective for amounts assessed after December 31, 1986, regardless of when the failure to pay began.

3. Negligence and Fraud Penalties (Sec. 503 of the bill and sec. 6653 of the Code)

Present Law

Negligence

Taxpayers are subject to a penalty if any part of an underpayment of tax is due to negligence or intentional disregard of rules or regulations (but without intent to defraud) (Code sec. 6653(a)). There are two components to this penalty. The first component is 5 percent of the total underpayment, where any portion of the underpayment is attributable to negligence or intentional disregard of rules or regulations. Thus, if a taxpayer has underpaid $1,000 in taxes and the portion due to negligence is $200, the amount of the penalty is $50 (5 percent of $1,000). The second component is an amount equal to one-half the interest rate that taxpayers must pay on underpayments of tax multiplied against the portion of the underpayment attributable to negligence or intentional disregard, for the period beginning on the last day prescribed for payment of the underpayment (without regard to any extension) and ending on the date of the assessment of the tax (or the date of payment of the tax, if that date is earlier).

Generally, once the IRS has determined that negligence existed, the burden is on the taxpayer to establish that the IRS' determination of negligence is erroneous. The taxpayer must meet a higher standard in the case of interest or dividend payments (sec. 6653(g)). This section provides that if the taxpayer fails to include in income an interest or dividend payment shown on an information return, the portion of the underpayment attributable to this failure is treated as due to negligence in the absence of clear and convincing

evidence to the contrary. The effect of this provision is that the IRS may automatically assert the negligence penalty in these circumstances, and the taxpayer must present clear and convincing evidence that no negligence was involved in order to avoid the penalty.

The negligence penalty applies only to underpayments of income taxes, gift taxes, and the windfall profits tax.

Fraud

Taxpayers are also subject to a penalty if any part of an underpayment of tax is due to fraud (sec. 6653(b)). This penalty is in lieu of the negligence penalty. There are two components to the fraud penalty. The first component is 50 percent of the total underpayment, where any portion of the underpayment is attributable to fraud. Thus, if a taxpayer has underpaid $1,000 in taxes and the portion due to fraud is $500, this component of the penalty is $500 (50 percent of $1,000). The second component is an amount equal to one-half the interest rate that taxpayers must pay on underpayments of tax, multiplied against the portion of the underpayment attributable to fraud, for the period beginning on the last day prescribed for payment of the underpayment (without regard to any extension) and ending on the date of the assessment of the tax (or the date of payment of the tax, if that date is earlier). The burden of proof is on the IRS to establish that fraud existed (sec. 7454(a)).

Reasons for Change

The committee is concerned that the negligence and fraud penalties have not been applied in a large number of cases where their application is fully justified. The committee has consequently modified several aspects of these penalties in order to improve their operation. In addition, however, the committee emphasizes that the IRS and the courts share significant responsibility to ensure that these penalties are fully asserted in appropriate instances.

In particular, the committee believes that the negligence penalty should apply to all taxes under the Code. The committee also believes that while the current special negligence penalty applicable to failure to include as income interest or dividends shown on an information return is appropriate, its scope is too narrow. The committee believes that, if a taxpayer is provided an information return with respect to an item that should appear on the taxpayer's tax return, but the taxpayer neglects to report that item, that taxpayer should be subject to a penalty. Consequently, the committee has expanded the scope of this special negligence penalty so that it applies (absent clear and convincing evidence to the contrary) to any item reported on an information return.

The committee is also concerned that the current applicability of the negligence and fraud penalties to the entire underpayment of tax (once the IRS has established either negligence or fraud with respect to any portion of the underpayment) may decrease the efficacy of these penalties. The committee is concerned that imposing the same penalty on two taxpayers who have identical underpayments, one attributable wholly to negligence or fraud and the other attributable only in part to negligence or fraud, may be an insuffi-

cient deterrent to negligent or fraudulent behavior. Consequently, the committee has narrowed the scope of the negligence penalty so that it applies only to the portion of the underpayment attributable to negligence. The committee has similarly narrowed the scope of the fraud penalty. The committee has concomitantly increased the level of both of these penalties. The committee believes that these modifications more appropriately target the negligence penalty to negligent behavior and the fraud penalty to fraudulent behavior.

Explanation of Provisions

Negligence

The bill expands the scope of the negligence penalty by making it applicable to all taxes under the Code. The bill also modifies the negligence penalty by increasing the rate of the penalty but at the same time narrowing its scope. First, the bill increases the rate of the negligence penalty from 5 to 10 percent. (The time-sensitive component of the negligence penalty is not altered.) Second, the scope of the negligence penalty is reduced so that in effect it applies only to the amount of the underpayment attributable to negligence (this is the same amount to which the present-law time-sensitive component of the negligence penalty applies). The negligence penalty is determined at the top marginal rate applicable to the taxpayer.

The bill also generally redrafts the negligence penalty to make it clearer and more comprehensible. One element of that redrafting involves the provision of a definition of negligence. The bill includes within the scope of the definition of negligence both any failure to make a reasonable attempt to comply with the provisions of the Code as well as any careless, reckless, or intentional disregard of rules or regulations. The bill does not, however, limit the definition of negligence to these items only. Thus, all behavior that is considered negligent under present law will remain within the scope of this negligence penalty. Also, any behavior that is considered negligent by the courts but that is not specifically included within this definition is also subject to this penalty.

The bill also expands the scope of the special negligence penalty that is currently applicable to failures to include in income interest and dividends shown on an information return. The bill expands this provision so that it is applicable to failures to show properly on the taxpayer's tax return any amount that is shown on any information return. This penalty applies to the same information returns that are subject to the penalties for failure to provide information returns, described above (new sec. 6724(d)(2)). Thus, if a taxpayer fails to show properly on the taxpayer's tax return any amount that is shown on an information return, the taxpayer's failure is treated as negligence in the absence of clear and convincing evidence to the contrary.

Fraud

The bill modifies the fraud penalty by increasing the rate of the penalty but at the same time narrowing its scope. First, the bill increases the rate of the basic fraud penalty from 50 to 75 percent.

(The time-sensitive component of the fraud penalty is not altered.) Second, the scope of the fraud penalty is reduced so that in effect it applies only to the amount of the underpayment attributable to fraud (this is the same amount to which the present-law time-sensitive component of the fraud penalty applies). The bill does this by providing that, once the IRS has established that any portion of an underpayment is attributable to fraud, the entire underpayment is treated as attributable to fraud, except to the extent that the taxpayer establishes that any portion of the underpayment is not attributable to fraud. This is done so that, once the IRS has initially established that fraud occurred, the burden of proof shifts to the taxpayer to establish the portion of the underpayment that is not attributable to fraud. The committee believes that this rule is appropriate in that these facts are generally within the taxpayer's control. It is nonetheless the intention of the committee that the fraud penalty apply only to the portion of the underpayment attributable to fraud. The fraud penalty is determined at the top marginal rate applicable to the taxpayer.[7]

These modifications to the fraud penalty do not affect the statute of limitations for false or fraudulent returns (sec. 6501(c)). Thus, if a taxpayer files a return that is in some respects fraudulent, the statute of limitations with respect to the entire return never expires.

Effective Date

The amendments to the negligence and fraud penalties are applicable to returns the due date of which (determined without regard to extensions) is after December 31, 1986.

4. Penalty for Substantial Understatement of Tax Liability (Sec. 504 of the bill and sec. 6661 of the Code)

Present Law

If a taxpayer substantially understates income tax for any taxable year, the taxpayer must pay an addition to tax equal to 10 percent of the underpayment of tax attributable to the understatement (sec. 6661). An understatement is substantial if it exceeds the greater of 10 percent of the tax required to be shown on the tax return or $5,000 ($10,000 in the case of most corporations). An understatement is generally the excess of the amount of tax required to be shown on a tax return over the amount of tax actually shown on the tax return. The penalty generally does not apply to amounts with respect to which (1) there was substantial authority for the taxpayer's treatment of the amount, or (2) the taxpayer discloses the relevant facts with respect to that amount on the tax return.

Reasons for Change

This penalty was originally enacted to deter taxpayers from participating in the "audit lottery," where taxpayers take questionable positions on their tax returns in the hope that they will not be au-

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[7] The IRS may issue regulations implementing this rule, including situations where both the fraud and negligence penalty apply.

dited. These taxpayers may be able to escape the negligence and fraud penalties, because they generally have relied upon the advise of a tax advisor. Reasonable and justifiable reliance on a tax advisor generally prevents the imposition of either the negligence or fraud penalty. The committee believes that the current level of the substantial understatement penalty provides an insufficient deterrent to this type of behavior; consequently, the committee has increased the level of this penalty.

Explanation of Provision

The bill increases the addition to tax for a substantial understatement of tax liability from 10 to 20 percent of the amount of the underpayment of tax attributable to the understatement.

Effective Date

The increase in this addition to tax is applicable to returns the due date of which (determined without regard to extensions) is after December 31, 1986.

5. Revenue Effect of Penalty Provisions

These penalty provisions are estimated to increase fiscal year budget receipts by $516 million for 1987, $436 million for 1988, $484 million for 1989, $487 million for 1990, and $491 million for 1991.

B. Interest Provisions

1. Differential Interest Rate (Sec. 511 of the bill and sec. 6621 of the Code)

Present Law

Taxpayers must pay interest to the Treasury on underpayments of tax (Code sec. 6601). Interest generally accrues from the due date of the tax return (determined without regard to extensions). The Treasury must pay interest to taxpayers on overpayments of tax (sec. 6611). Both the rate taxpayers pay to the Treasury and the rate the Treasury pays to taxpayers are the same rate (sec. 6621). That rate is determined semi-annually for the 6-month periods ending on September 30 and March 31. The adjusted rate takes effect on the following January 1 (for September 30 determinations) and July 1 (for March 31 determinations). The rate utilized is the prime rate quoted by large commercial banks as determined by the Board of Governors of the Federal Reserve System.

Reasons for Change

The committee is concerned that these interest provisions are not modeled sufficiently closely on other interest rates in the economy; this may have distortive effects. First, the committee is concerned that both the interest rate taxpayers pay the Treasury and the rate the Treasury pays to taxpayers are the same rate. Few financial institutions, commercial operations, or other entities, borrow and lend money at the same rate. Thus, either the rate taxpayers pay the Treasury or the rate the Treasury pays taxpayers is necessarily out of line with general interest rates in the economy. This distortion may cause taxpayers either to delay paying taxes as long as possible to take advantage of an excessively low rate or to overpay to take advantage of an excessively high rate. Consequently, the committee has approved a one-percent differential between these two interest rates.

Second, the committee is concerned that the prime rate, which is the basis for interest determinations under present law, is not as reflective of actual market rates involving transactions with the Government as other rates are. Consequently, the committee has based the interest rate on the Federal short-term rate.

Explanation of Provision

The bill provides that the interest rate that Treasury pays to taxpayers on overpayments is the Federal short-term rate plus 2 percentage points. The bill also provides that the interest rate that taxpayers pay to the Treasury on underpayments is the Federal

short-term rate plus 3 percentage points. The rates are rounded to the nearest full percentage.

The interest rates are to be adjusted quarterly. The rates are determined during the first month of a calendar quarter, and become effective for the following calendar quarter. Thus, for example, the rates that are determined during January are effective for the following April through June. This reduces by one month (from three months to two) the lag that exists in present law between the determination of the interest rate and the date it becomes effective.

The interest rates are determined by the Secretary based on the average market yield on outstanding marketable obligations of the United States with remaining periods to maturity of three years or less. This is the mechanism for determining short-term Federal rates, which are used to test the adequacy of interest in certain debt instruments issued for property and certain other obligations (see sec. 1274(d)).

Taxpayers subject to differential interest rates may have an underpayment for a type of tax in one taxable year and an overpayment for the same type of tax in another taxable year. The IRS requires substantial lead time to develop the data processing capability to net such underpayments and overpayments in applying differential interest rates. The bill, therefore, provides that the Secretary of the Treasury may prescribe regulations providing for netting of tax underpayments and overpayments through the period ending three years after the date of enactment of the bill. By that date, the committee expects that the IRS will have implemented computerized netting procedures.

Effective Date

This provision is effective for purposes of determining interest for periods after December 31, 1986.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $297 million for 1987, $504 million for 1988, $368 million for 1989, $425 million for 1990, and $554 million for 1991.

2. Interest on Accumulated Earnings Tax (Sec. 512 of the bill and sec. 6601 of the Code)

Present Law

The accumulated earnings tax (sec. 531) is imposed to prevent corporations from accumulating (rather than distributing) income with the intent of reducing or avoiding taxes. Interest is charged only from the date the IRS demands payment of the tax, rather than the date the return was originally due to be filed.[8]

Reasons for Change

The committee believes that it is appropriate to impose interest on underpayments of the accumulated earnings tax in the same

[8] See Rev. Rul. 72-324, 1972-1 C.B. 399.

manner that interest is imposed for most other taxes in the Code. Consequently, interest is imposed under the bill from the date the return was originally due to be filed.

Explanation of Provision

The bill provides that interest is imposed on underpayments of the accumulated earnings tax from the due date (without regard to extensions) of the income tax return for the year the tax is initially imposed.

Effective Date

This provision is effective for returns that are due (without regard to extensions) after December 31, 1986.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by a negligible amount.

C. Information Reporting Provisions

1. Information Reporting on Real Estate Transactions (Sec. 521 of the bill and sec. 6045 of the Code)

Present Law

Brokers must, when required by Treasury regulations, file information returns on the business they transact for customers (sec. 6045). To date, the IRS has issued regulations requiring reporting only of gross proceeds of sales of securities, commodities, regulated futures contracts, and precious metals. Reporting on real estate transactions is not currently required under these regulations. The term "broker" is broadly defined as any person who, in the ordinary course of a trade or business, stands ready to effect sales to be made by others (Treas. Reg. sec. 1.6045-1).

Reasons for Change

The committee is concerned that a sizeable number of real estate transactions that should be reported on tax returns are not being reported. Consequently, the committee has determined that it is appropriate to expand the current system of information reporting to include reporting on real estate transactions. The committee has imposed the primary responsibility for reporting on real estate brokers, because doing so enables the information reporting system to operate most efficiently.

Explanation of Provision

The bill requires that real estate transactions be reported. The seller's real estate broker (including a representative or agent) is the first person responsible to do the information reporting. If there is no seller's real estate broker, then the reporting is to be done by the buyer's real estate broker (including a representative or agent). If there is no buyer's real estate broker, then the reporting is to be done by the mortgage lender. If there is more than one mortgage lender, the reporting is to be done by the primary mortgage lender. If there is no mortgage lender, the reporting is to be done by the title company. If there is no title company, the reporting is to be done by the settlement attorney or other person responsible for closing the transaction. If there is no settlement attorney, the reporting is to be done in accordance with regulations to be prescribed by the Treasury.

The committee anticipates that this reporting will be done on a Form 1099, similar to that required for other transactions effected by brokers. The committee also anticipates that the rules requiring that information returns from brokers be filed on magnetic media (see sec. 6011(e)) will encompass these information returns on real

estate. Because the provision is drafted so that reporting on real estate transactions is done under the general information reporting requirements relating to brokers (sec. 6045(a) and (b)), all penalties and related provisions that apply to the general broker reporting requirements also apply to reporting on real estate transactions.

The bill provides that real estate transactions will be subject to backup withholding (sec. 3406) only to the extent required by Treasury regulations. The committee expects Treasury to provide taxpayers with guidance as to how backup withholding is to be implemented with respect to real estate transactions.

Effective Date

The provision is effective for real estate transactions with respect to which closing on the contract occurs on or after January 1, 1987. Real estate transactions on or after that date must be reported without regard as to whether the Treasury has issued regulations under section 6045(a) requiring that a return be filed. Thus, this provision (unlike the general broker reporting requirements of section 6045) is effective in the absence of implementing regulations. The committee expects that the IRS will provide taxpayers with timely guidance as to how to comply with the requirements of this provision.

2. Information Reporting on Persons Receiving Contracts From Certain Federal Agencies (Sec. 522 of the bill and new sec. 6050M of the Code)

Present Law

There is no provision of present law that requires information reporting on persons receiving Federal contracts.

Reasons for Change

The committee is concerned that the dollar amount of taxes owed to the Federal Government that the IRS has attempted repeatedly to collect but cannot collect has grown in recent years to over $9.1 billion. The committee is also concerned that those who reap the benefits of Federal contracts also fulfill their Federal obligation of paying their taxes. Therefore, the committee has determined that it is appropriate to require information reporting from a Federal agency that enters into a contract. These information returns will notify the IRS of a source from which delinquent taxes may be collected, which will facilitate the collection of these delinquent taxes.

Explanation of Provision

The bill requires the head of Federal executive agencies to file an information return indicating the name, address, and taxpayer identification number (TIN) of each person with which the agency enters into a contract. The Secretary of the Treasury has the authority to require that the returns be in such form and be made at such time as is necessary to make the return useful as a source of information for collection purposes. Thus, it would be appropriate

to require that these information returns be filed within a certain time period (such as 30 days) of signing the contract, rather than at the end of the calendar year. The Secretary is given the authority both to establish minimum amounts for which no reporting is necessary as well as to extend the reporting requirements to Federal license grantors and subcontractors of Federal contracts.

In some instances, several corporations, each with its own TIN, file one consolidated return. The Secretary has the authority to require that the information returns include the corporation's own TIN, as well as the TIN under which it files the consolidated return, so that the matching of Federal contracts with delinquent tax liability can be facilitated.

The new provision does not enlarge the collection procedures now available to the Service. Rather, these new returns will provide the IRS with a possible source of collection in the event taxes are unpaid.

Effective Date

This provision is effective on January 1, 1987. Thus, all contracts signed on or after that date are subject to information reporting. In addition, all contracts signed prior to that date are subject to information reporting if they are still in effect on that date.

3. Information Reporting on Royalties (Sec. 523 of the bill and new sec. 6050N of the Code)

Present Law

A number of provisions of the Code require that payors of specified payments report those payments to the IRS and provide a copy of the information report to the taxpayer receiving the payment. Section 6041 is the broadest of these provisions; this section requires information reporting on "rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable gains, profits, and income." The Treasury regulations for this section specifically require information reporting on royalties.

Information reporting under section 6041 applies to payments totalling $600 or more during the taxable year. Other information reporting provisions, such as those for interest (section 6049), dividends (section 6042), patronage dividends (section 6044), and unemployment compensation (section 6050B), apply to payments totalling $10 or more during the taxable year.

Reasons for Change

The committee is concerned that the voluntary reporting level for royalties is appreciably lower than it is for many other types of income. One reason for this is that some payors currently required to report on royalties are not doing so. This may occur because of the lack of specificity in the present-law requirements. Another reason that voluntary reporting on royalties may be inadequate is that the dollar level at which payments are reported under present law is higher than it is for many other types of payments, such as interest or dividends. Consequently, the committee has both made

the information reporting requirements with respect to royalties more specific and lowered the threshold level at which this information reporting begins to conform it to interest and dividend reporting.

Explanation of Provision

The bill includes a new provision of the Code that requires that persons who make payments of royalties aggregating $10 or more to any other person in a calendar year must provide an information report on the royalty payments to the IRS. A copy of this information report must be supplied to the taxpayer. If the payor reports to a nominee, the nominee must report the information to the taxpayer and to the IRS, as required in Treasury regulations. Examples of royalty payments required to be reported under this provision include royalty payments with respect to the right to exploit natural resources, such as oil, gas, coal, timber, sand, gravel, and other mineral interests, as well as royalty payments for the right to exploit intangible property, such as copyrights, trade names, trademarks, books and other literary compositions, musical compositions, artistic works, secret processes or formulas, and patents.

The generally applicable rules for information returns for payments of interest and dividends apply to this provision. Thus, the information report to the taxpayer must be provided by the end of January and the report to the IRS must be provided by the end of February. Payors filing large numbers of these reports with the IRS are subject to the magnetic media filing requirements of section 6011(e). If the payee does not furnish the payor with the payee's taxpayer identification number (for individuals, the social security number), the royalty payments generally are subject to backup withholding.

Effective Date

This provision is effective for royalty payments made after December 31, 1986.

4. Modification of Separate Mailing Requirement for Certain Information Reports (Secs. 501(c) (2), (3) and (5) and 523 of the bill and secs. 6042, 6044, and 6049 and new sec. 6050N of the Code)

Present Law

Payors of interest, dividends, and patronage dividends are required to report to the IRS the amounts of these payments that the payors make (secs. 6042, 6044, and 6049). Payors are required to provide a copy of this information report to the taxpayer who received the payment. These information reports must be made on the official IRS form (Form 1099). The Code requires that the copy of the information report supplied to the taxpayer must be provided either in person or in a separate, first-class mailing. Generally, nothing other than the information report is permitted to be enclosed in the envelope.

Reasons for Change

The committee is concerned that the separate mailing requirement for information returns may impose significant burdens on payors. At the same time, however, the committee is concerned that there be no significant degradation in voluntary compliance with respect to the reporting of these payments on taxpayers' tax returns. Consequently, the committee has made specific modifications to the separate mailing requirement that will reduce the burden on payors but at the same time will not substantially diminish voluntary reporting by taxpayers.

Explanation of Provision

The bill provides that payors of interest, dividends, patronage dividends, and royalty payments must provide copies of information returns to the taxpayer either in person (as is provided under present law) or in a statement mailing by first-class mail. The only enclosures that can be made with a statement mailing are: (1) a check, (2) a letter explaining why no check is enclosed (such as, for example, because a dividend has not been declared payable), or (3) a statement of the taxpayer's specific account with the payor (such as a year end summary of the taxpayer's transactions with the payor).[9] The envelope must state on the outside "Important Tax Return Document Enclosed." In addition, each enclosure (i.e. the check, the letter, or the account statement) must state "Important Tax Return Document Enclosed." A mailing is not a statement mailing if it encloses any other material such as advertising, promotional material, or a quarterly or annual report. The committee did not permit additional material such as this to be enclosed because such enclosures may make it less likely that some taxpayers will recognize the importance of the information report and utilize the information report in completing their tax returns. The committee retains the requirement of present law that the information return be made on an official form.

Effective Date

This provision is effective for information returns required to be filed after December 31, 1986.

Revenue Effect of Information Reporting Provisions

These information reporting provisions are estimated to increase fiscal year budget receipts by $68 million in 1987, $387 million in 1988, $493 million in 1989, $628 million in 1990, and $648 million in 1991.

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[9] These are in addition to the other enclosures, such as other information reports or tax forms, that the IRS currently permits to be enclosed.

D. Tax Shelters

1. Tax Shelter User Fee (Sec. 531 of the bill and sec. 6662 of the Code)

Present Law

The cost of administering the tax law with respect to tax shelters is paid as part of the overall IRS budget, which is funded from general revenues. This cost is approximately $165 million annually, and includes audits, examination, appeals, litigation, and criminal investigation. No specific fee is imposed on tax shelters or tax shelter-related audits or investigations to offset this cost.

Reasons for Change

The committee believes that it is appropriate that those who claim tax benefits from tax shelters pay the cost to the Government of administering the law with respect to tax shelters.

Explanation of Provision

The bill requires taxpayers who, with respect to each tax shelter, claim on their tax returns cumulative net losses (plus three times the value of cumulative tax credits) that exceed cumulative actual cash invested in the tax shelter to pay a user fee of 1 percent of the losses claimed and 3 percent of the credits claimed with respect to that tax shelter. These percentages are set at a level that will raise revenue approximately equal to the estimated IRS cost of administering the law with respect to tax shelters.

"Tax shelter" is defined as:

(1) any enterprise required to register with a Federal or State securities agency (other than a C corporation);

(2) any syndicate more than 35 percent of the losses of which are allocable to limited partners or limited entrepreneurs; or

(3) any plan or entity the principal purpose of which is to avoid or evade Federal income taxes.

(These definitions are currently used in section 461(i) of the Code.)

This user fee is non-deductible. In addition, the bill doubles the user fee if the taxpayer does not pay the user fee with the tax return.

Effective Date

The provision is effective for returns filed after December 31, 1986.

2. Tax Shelter Registration (Sec. 532 of the bill and sec. 6111 of the Code)

Present Law

Tax shelter organizations are required to register with the IRS tax shelters they organize, develop, or sell (sec. 6111). A tax shelter is any investment for which the ratio of the deductions plus 200 percent of the credits to the cash actually invested is greater than 2 to 1. The investment also must (1) be subject to Federal or State securities requirements, or (2) be privately placed with 5 or more investors with an aggregate amount that may be offered for sale exceeding $250,000.

Reasons for Change

Multiplying tax credits by 200 percent yields the equivalent value of those credits in terms of deductions at a 50-percent rate of tax. If the tax rate is lowered (as is done in this bill), the percentage against which tax credits must be multiplied must be increased in order to maintain the proper conversion of those credits into deduction-equivalents.

Explanation of Provision

Tax credits are multiplied by 375 percent (instead of 200 percent) to conform the tax shelter ratio computation more closely to the new tax rate schedule in this bill.

Effective Date

This provision is effective July 1, 1987 (the same date that the rate changes are effective).

3. Tax Shelter Penalties

a. Penalty for failure to register a tax shelter (sec. 533 of the bill and sec. 6707(a) of the Code)

Present Law

Specified tax shelters are required to register with the IRS and obtain a tax shelter identification number (see previous item). The penalty for failure to register a tax shelter with the IRS is $10,000 or, if less, one percent of the aggregate amount invested in the tax shelter (but in no event less than $500) (sec. 6707(a)).

Reasons for Change

The committee believes that registration of tax shelters is an important tool that enables the IRS to detect questionable shelters at the early stages of their development. The committee believes that the present-law minimum penalty of $500 may be an insufficient deterrent for failure to register a tax shelter. Consequently, the committee has increased the minimum amount of the penalty.

Explanation of Provision

The bill increases the level of this penalty to the greater of one percent of the aggregate amount invested in the tax shelter or $10,000.

Effective Date

This provision is effective on the date of enactment.

b. Penalty for failure to report the tax shelter identification number (sec. 534 of the bill and sec. 6707(b) of the Code)

Present Law

If a taxpayer invests in a tax shelter that has a tax shelter identification number, the taxpayer is required to include that number on the taxpayer's tax return (sec. 6707(b)). The penalty for failure to do so is $50, unless the failure is due to reasonable cause.

Reasons for Change

In order for the tax shelter registration system to function properly, taxpayers must report the tax shelter identification numbers on their tax returns. The committee believes that the present-law penalty for failure to do so is too low.

Explanation of Provision

The bill increases the penalty for failure to report a tax shelter identification number on a tax return from $50 to $250. The present-law exception from the penalty where the failure to report the number is due to reasonable cause remains unchanged.

Effective Date

The provision is effective for tax returns filed after the date of enactment.

c. Penalty for failure to maintain lists of tax shelter investors (sec. 535 of the bill and sec. 6708 of the Code)

Present Law

Organizers and sellers of specified tax shelters are required to maintain lists of investors (sec. 6112). The penalty for failure to do so is $50 for each name missing from the list, unless the failure is due to reasonable cause, up to a maximum of $50,000 per year (sec. 6708).

Reasons for Change

The committee believes that the requirement that tax shelter organizers and sellers maintain lists of investors provides the IRS with an important mechanism to identify quickly all of the participants in tax-shelter investments and consequently to treat all participants more uniformly. Accordingly, the committee believes that it is appropriate to raise the level of this penalty commensurate

with the importance of the requirement to maintain lists of tax-shelter investors.

Explanation of Provision

The bill increases the penalty for failure to maintain lists of tax shelters from $50 to $100 per name omitted. The bill also increases the maximum penalty that can be imposed in any calendar year from $50,000 to $100,000. The present-law exception from the penalty where the failure to include a name on a list is due to reasonable cause and not to willful neglect remains unchanged.

Effective Date

The increase in this penalty is effective on the date of enactment of the bill.

4. Tax Shelter Interest (Sec. 536 of the bill and sec. 6621(d) of the Code)

Present Law

Taxpayers who underpay their taxes must pay interest. If the interest is attributable to an underpayment of tax of more than $1,000 that is attributable to a tax-motivated transaction (such as a tax shelter), interest is computed at 120 percent of the generally applicable interest rate.

Reasons for Change

The committee believes that it is appropriate that taxpayers who engage in tax-motivated transactions pay an increased rate of interest on underpayments of tax attributable to those tax-motivated transactions.

Explanation of Provision

The bill increases the rate of interest computed with respect to underpayments of tax attributable to tax-motivated transactions from 120 percent to 200 percent of the generally applicable interest rate.

Effective Date

The provision is effective for interest accruing after December 31, 1986.

Revenue Effect of Tax Shelter Provisions

These provisions are estimated to increase fiscal year budget receipts by $15 million for 1987, $88 million for 1988, $54 million for 1989, and by less than $5 million annually for 1990 and 1991. (The revenue effect of the tax shelter user fee is related to (and included in) the revenue effect of the provision limiting losses and credits from passive activities.)

E. Estimated Tax Payments by Individuals (Sec. 561 of the bill and sec. 6654 of the Code)

Present Law

Individuals owing tax who do not make estimated tax payments are generally subject to a penalty (Code sec. 6654). In order to avoid the penalty, individuals must make quarterly estimated tax payments that equal at least the lesser of 100 percent of last year's tax liability or 80 percent of the current year's tax liability. Amounts withheld from wages are considered to be estimated tax payments.

Reasons for Change

The committee believes that it is important for the proper functioning of the tax system that taxpayers be relatively current in paying their tax liability. In light of the fact that most taxpayers have taxes withheld from each paycheck and that wage withholding closely approximates tax liability[10] for many of these taxpayers, the committee believes that it is appropriate to require that taxpayers making estimated tax payments keep similarly current in their payments.

Explanation of Provision

The bill increases from 80 percent to 90 percent the proportion of the current year's tax liability that taxpayers must make as estimated tax payments in order to avoid the estimated tax penalty. The alternate test of 100 percent of the preceding year's liability remains unchanged.

Effective Date

This provision is effective with respect to taxable years beginning after December 31, 1986. Thus, the estimated tax payment due January 15, 1987, which is the final payment for taxable year 1986, is unaffected by this provision. All subsequent estimated tax payments are, however, subject to this provision.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $1,385 million for 1987, $75 million for 1988, $44 million for 1989, $104 million for 1990, and $80 million for 1991.

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[10] In fact, a number of these taxpayers are overwithheld. A substantial portion of overwithholding appears to occur because of taxpayer preference, however, rather than widespread defects in the withholding system.

F. Tax Litigation and Tax Court

1. Awards of Attorney's Fees in Tax Cases (Sec. 541 of the bill and sec. 7430 of the Code)

Present Law

The Civil Rights Attorney's Fees Awards Act of 1976

The Civil Rights Attorney's Fees Awards Act of 1976 (42 U.S.C. sec. 1988) provides, in part, that in any civil action or proceeding brought by or on behalf of the United States to enforce, or charging a violation of, a provision of the Internal Revenue Code, the court in its discretion may allow the prevailing party, other than the United States, reasonable attorney's fees as a part of the costs. This provision is limited to actions brought by or on behalf of the Federal Government (that is, to cases in which the taxpayer is the defendant). Most civil tax litigation is initiated by the taxpayer who brings suit against the Government. In the United States Tax Court, the taxpayer is the petitioner in a deficiency proceeding. In the Federal district courts and the U.S. Claims Court, the taxpayer is the plaintiff suing the Government for a refund.

The Equal Access to Justice Act

In 1980, as part of Public Law 96-481, Congress enacted the Equal Access to Justice Act (28 U.S.C. sec. 2412) which, in part, authorizes awards to a prevailing party, other than the United States, of attorney's fees and other expenses, unless the court finds that the position of the United States was substantially justified or that special circumstances make an award unjust. This provision applies, specifically, to cases in Federal district courts and the United States Claims Court. However, the provision is not applicable to cases in the United States Tax Court.[11]

The provision became effective on October 1, 1981. The provision repealed the applicability of the Civil Rights Attorney's Fees Awards Act of 1976 to tax litigation.

Under the Equal Access to Justice Act, fees and other expenses that may be awarded to a prevailing party include the reasonable expenses of expert witnesses, the reasonable cost of any study, analysis, engineering report, test, or project which is found by the court to be necessary for the preparation of the party's case, and reasonable attorney's fees. In general, no expert witness may be compensated at a rate that exceeds the highest rate of compensation for expert witnesses paid by the United States. Attorney's fees

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[11] This is because the Equal Access to Justice Act is contained in Title 28 of the United States Code, which deals with courts created under Article III of the United States Constitution. The United States Tax Court was established under Article I of the United States Constitution.

in excess of $75 per hour may not be awarded unless the court determines that a higher fee is justified.

Code section 7430

In general, Code section 7430 authorizes the award of reasonable litigation costs, including attorney's fees and court costs, to a taxpayer who prevails in a tax case in any Federal court. Such costs may be awarded whether the action was brought by or against the taxpayer. No award may be made to the Government if the taxpayer does not prevail, or to any creditor of a prevailing taxpayer.

Section 7430 is the exclusive provision for awards of litigation costs in any action or proceeding to which it applies.

The amount that may be awarded for litigation costs in a particular proceeding (such as a Tax Court case) may not exceed $25,000. This limitation applies regardless of the number of parties to the proceeding or the number of tax years at issue.

Section 7430 authorizes an award of reasonable litigation costs only if the taxpayer establishes that the position of the Government in the case was unreasonable and the taxpayer has substantially prevailed with respect to the amount in controversy or the most significant issue or set of issues presented. The determination by the court on this issue is made on the basis of the facts and legal precedents relating to the case as revealed in the record.

No award may be made unless the court determines that the taxpayer had exhausted all administrative remedies available within the Internal Revenue Service.

Section 7430, which was enacted in the Tax Equity and Fiscal Responsibility Act of 1982, became effective for cases begun after February 28, 1983. Under present law, the provision does not apply to any proceeding commenced after December 31, 1985.

Damages assessable for instituting proceedings before the Tax Court merely for delay

Under present law, if it appears to the Tax Court that proceedings before it have been instituted or maintained by a taxpayer primarily for delay, or that the taxpayer's position in the proceedings is frivolous or groundless, then the court may award damages to the United States. Such damages cannot exceed $5,000 (sec. 6673).

Reasons for Change

The committee believes that the provision allowing awards of attorney's fees should be continued but must be modified to provide greater consistency between the laws governing the awards of attorney's fees in tax and nontax cases. Specifically, the committee believes that the Equal Access to Justice Act provides the appropriate standards for awarding attorney's fees.

Explanation of Provision

The bill modifies section 7430 to conform it more closely to the Equal Access to Justice Act. Consequently, under the bill, the burden of proof is on the Government to prove that its position was substantially justified or that special circumstances exist that make an award of attorney's fees and court costs unjust. The bill

provides that, unless the Government proves this, attorney's fees may be awarded. This burden of proof replaces the standard under section 7430 that requires the taxpayer to prove that the Government's position was unreasonable before the taxpayer could be awarded attorney's fees. Furthermore, the "substantially justified" standard is applicable to prelitigation actions or inaction of Government agents as well as the litigation position of the Government. The bill does not modify the present-law requirement that, in order to be eligible to be awarded attorney's fees, the taxpayer must either substantially prevail with respect to the amount in controversy or substantially prevail with respect to the most significant issue or set of issues presented. The bill also does not modify the present-law provision that only the taxpayer (and not the Government) may be awarded attorney's fees.

The bill eliminates the $25,000 cap on the award of attorney's fees and substitutes a $75 an hour limitation on attorney's fees, unless the court determines that a higher rate is justified. To make this determination, the court may look to an increase in the cost of living or a special factor, such as the limited availability of qualified attorneys to deal with the particular issues involved in the case. As under prior law, only reasonable litigation costs are recoverable by the taxpayer. Unlike prior law, however, prevailing market rates are applied to determine what are reasonable expenses of expert witnesses and reasonable costs of any study, analysis, or other project necessary to the preparation of the taxpayer's case. In no event are expert witnesses to be compensated at a rate in excess of the highest rate of compensation for expert witnesses paid by the United States.

The bill also denies any award to a prevailing party who unreasonably protracts the proceedings. Although this requirement is part of the Equal Access to Justice Act, it has not previously applied to Tax Court cases.

Effective Date

This provision applies to proceedings commenced after December 31, 1985, with no sunset date. However, no payments may be made as a result of this provision before October 1, 1986.

Budget Effect

This provision is estimated to increase fiscal year budget outlays by less than $5 million annually.

2. Tax Court Provisions

a. Tax Court practice fee (sec. 542 of the bill and new sec. 7475 of the Code)

Present Law

The Tax Court imposes a $25 application fee prior to admission to practice before the Court (Tax Court Rule 200). No fee is imposed after the application fee has been paid.

The Tax Court rules authorize the Court to initiate disciplinary proceedings against practitioners who appear before it (Tax Court

Rule 202). The Court is authorized to appoint independent counsel to pursue disciplinary matters.

Reasons for Change

The committee believes that it is appropriate to permit the Tax Court to impose a practice fee, the proceeds of which are to be used to pay outside counsel to pursue disciplinary matters.

Explanation of Provision

The bill authorizes the Tax Court to impose a periodic registration fee on practitioners admitted to practice before it. The Tax Court is to establish the level of the fee and the frequency of its collection, but the fee may not exceed $30 per year. These funds are available to the Tax Court to pay independent counsel engaged by the Court to pursue disciplinary matters.

Effective Date

This provision is effective January 1, 1987.

b. Clarification of jurisdiction over penalty for failure to pay tax (sec. 543 of the bill and sec. 6214 of the Code)

Present Law

The Tax Court has held that it does not have jurisdiction over the addition to tax for failure to pay the amount of tax shown on the taxpayer's return, even though it has jurisdiction to redetermine a deficiency in tax with respect to that return (*Est. of Young* v. *Comm'r*, 81 T.C. 879 (1983)).

Reasons for Change

The committee believes that it is appropriate for the Tax Court to have jurisdiction over this addition to tax if it already has jurisdiction with respect to that tax return.

Explanation of Provision

The bill provides that the Tax Court has jurisdiction over this addition to tax for failure to pay an amount shown on the return where the Tax Court already has jurisdiction to redetermine a deficiency in tax with respect to that return.

Aside from resolving this jurisdictional issue, the provision does not alter the jurisdiction of the Tax Court. The amendment is not intended to change existing law insofar as (1) the section 6651(a)(1) late filing addition to tax, or (2) the procedure for assessing additions to tax under section 6663(b) is concerned.

Effective Date

This provision is effective for any action or proceeding before the Tax Court which has not become final before the date of enactment.

c. U.S. Marshals (Sec. 544 of the bill and sec. 7456 of the Code)

Present Law

United States Marshals provide courtroom security, among other duties. It is not clear that the Tax Court has the authority to request the assistance of U.S. Marshals, because the Tax Court is an Article I (rather than Article III) court.

Reasons for Change

The committee believes that it is vital that the Tax Court be able to request the assistance of U.S. Marshals to provide courtroom security for the Tax Court.

Explanation of Provision

The bill requires that the U.S. Marshal for any district in which the Tax Court is sitting must attend any session of the Tax Court, when requested to do so by the Chief Judge of the Tax Court.

Effective Date

This provision is effective on the date of enactment of the bill.

d. Special Trial Judges (Sec. 545 of the bill and new sec. 7443A of the Code)

Present Law

The Chief Judge of the Tax Court is authorized to appoint Special Trial Judges, who assist in the work of the Court. The Code provides that their salary is determined by the procedures relating to the Commission on Executive, Legislative, and Judicial Salaries. The Executive Order implementing that provision fails to include Special Trial Judges.

Prior to January 17, 1985, Special Trial Judges were entitled to reimbursement for travel expenses on the same basis as other Federal judges. On that date, the Comptroller General determined that they were entitled only to reduced reimbursement pursuant to the Federal Travel Regulations.

Reasons for Change

The committee believes that, in view of the vital role that the Special Trial Judges have, it is important to clarify these provisions.

Explanation of Provision

The bill consolidates in one new section of the Code a number of the provisions relating to the Special Trial Judges. The bill also specifies that Special Trial Judges are to be paid 90 percent of the salary paid to Tax Court Judges, and that Special Trial Judges are to be reimbursed for travel and subsistence expenses to the same extent as are Tax Court Judges.

Effective Date

Generally, these provisions are effective on the date of enactment of the bill. The provision relating to the salary of Special Trial Judges is effective on the first day of the first month beginning after the date of enactment.

e. Election to practice law after retirement and receive retirement pay (sec. 546 of the bill and secs. 7447 and 7448 of the Code)

Present Law

United States District Court judges meeting age and longevity of tenure requirements may resign, engage in the practice of law, and continue to receive retirement pay. This retirement pay is not, however, adjusted to reflect changes in the pay of active District Court judges.

Retired Tax Court judges who engage in the practice of Federal tax or contract renegotiation law forfeit all retirement pay. Forfeiture also occurs if a retired Tax Court judge accepts another Government position, whether compensated or not.

Reasons for Change

The committee believes that it is appropriate for Tax Court judges to be able to choose to resign and practice law on the same basis that United States District Court judges are eligible to do.

Explanation of Provision

The bill permits Tax Court judges meeting specified age and tenure requirements to elect to receive full retired pay as of the date they make the election (which would not be adjusted to reflect changes in the pay of active Tax Court judges) and not be subject to the prohibition on practicing tax law. The bill also suspends retired pay for the period of time during which a retired Tax Court judge holds a compensated Government position.

Effective Date

This provision generally is effective on the date of enactment.

Budget Effects

The budget effects of the Tax Court provisions are negligible.

G. Tax Administration Trust Fund (Sec. 558 of the bill and new sec. 9505 of the Code)

Present Law

The Internal Revenue Service is responsible for administering almost all of the tax laws.[12] The cost of the entire IRS is funded through annual appropriations of general revenues. There are several trust funds in the Trust Fund Code of the Internal Revenue Code. These are generally financed from earmarked taxes.

Reasons for Change

The committee is concerned that the IRS has not been funded in recent years at a high enough level to assure adequate administration of the tax laws. For example, in the last 10 years, the percentage of tax returns that are audited has declined by approximately half. In addition, the total of taxes owed but uncollected has risen substantially in recent years. IRS studies indicate that the tax gap (the difference between taxes legally owed and taxes voluntarily paid) is increasing each year, and is now $100 billion a year. Declining compliance helps to create an impression among the public that the tax system is unfair. In spite of these difficulties, over 95 percent of Federal budget receipts are attributable to IRS tax administration activities.

In light of both the importance of the IRS in ensuring collection of Federal revenues and the recent difficulties it has experienced in securing adequate funding, the committee believes that it is appropriate to use a new approach to assure adequate funding for the IRS. Consequently, the committee establishes a Tax Administration Trust Fund, financed from all interest and penalties received under the Internal Revenue Code. In addition, the committee believes that it is vital to provide the IRS with a substantial increase in funding beyond what has been available to it in recent years. Consequently, the commitee has provided a substantial increase (beyond current levels) to the IRS. The committee has targeted this increase so that the IRS can increase its examination, collection, and related tax compliance activities.

The committee believes that it is appropriate to reevaluate the efficacy of this mechanism after it has been operational for several years. Accordingly, the Trust Fund will operate for five years; it is then scheduled to expire. The balance in the Trust Fund after the end of the five years will revert to the general fund of the Treasury.

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[12] The Bureau of Alcohol, Tobacco, and Firearms administers the alcohol, tobacco, and firearms excise taxes.

Explanation of Provisions

In general

The bill establishes a Tax Administration Trust Fund in the Treasury. The Trust Fund is funded by appropriation of (1) all interest paid by taxpayers on deficiencies and (2) penalties (such as, for example, for fraud and negligence) and additions to tax received under the Internal Revenue Code. Amounts in the Trust Fund (subject to limitations described below) may be utilized by the IRS without additional appropriations legislation. The Trust Fund will fund a level of IRS spending approximately equivalent to current spending plus a sizeable increase each year. The increase is targeted to examination, collection, and other increased compliance measures.

Spending purposes

The bill specifies the amounts that the IRS can expend from the Trust Fund for each of the next five fiscal years, 1987 through 1991.

Following are the total amounts that may be spent by the IRS for each of the next five fiscal years:

	[In millions]
FY 1987	$4,340
FY 1988	4,647
FY 1989	4,924
FY 1990	4,978
FY 1991	5,033

The committee provides a substantial increase in IRS spending over current levels. The committee intends that this increase be spent in the following manner:

	Fiscal Years (millions of dollars)				
	1987	1988	1989	1990	1991
Increased collection	21	62	104	104	104
Increased examination	130	231	342	351	356
Improved automated matching of information returns with tax returns	76	192	254	235	215
Improved automated data processing (equipment and staffing)	115	120	125	130	136
Improved audit selection and compliance research	25	25	25	25	25
Improved taxpayer service and correspondence	60	60	60	60	60
Staffing for tax litigation, chief counsel, pension plans, tax-exempt organizations, inspection, and statistics of income	37	37	37	37	37

The amounts to be spent from the Trust Fund include appropriate increases reflecting projected inflation and workload increases. Pay increases are not included in the dollar totals; instead, the bill provides that increases resulting from adjustments in salary, retirement, and other benefits required by law may also be spent from the Trust Fund, without the need for additional appropriations legislation.

The committee recognizes that it is difficult to project today the precise nature of the tax system and the needs for administering it during the next five years. Consequently, the IRS may make adjustments in the allocations described above, so long as the adjustments are consistent with the committee's intent in creating the Trust Fund. Additionally, if major adjustments to the Trust Fund were to be needed, the IRS should inform the committee of any necessary modifications to the Trust Fund. Alternatively, the IRS could request additional appropriations to meet their needs.

Trust Fund

The Tax Administration Trust Fund is established as part of the Trust Fund Code of the Internal Revenue Code (chapter 98). Amounts equivalent to all interest and penalties received under the Code are to be transferred to the Trust Fund. This is to be done on the basis of current estimates of those receipts, with later adjustment to be made to reflect actual receipts of interest and penalties. (This is the same procedure that is employed with respect to the transfer of receipts to other trust funds in the Trust Fund Code (sec. 9601).)

The Trust Fund is given limited borrowing authority in the first year from the Treasury. Amounts borrowed must be repaid with interest. This is done so that during the first year the Trust Fund is effective, there will be sufficient funds in the Trust Fund to meet its obligations. The committee expects that the Trust Fund will be adequately funded over the five-year period, but that during the first year receipts may temporarily lag behind authorized expenses.

Effective Date

The Trust Fund is effective October 1, 1986 (the start of the 1987 fiscal year). It expires on September 30, 1991. All amounts remaining in the Trust Fund after that date revert to the general fund of the Treasury.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $1,547 million in 1987, $2,837 million in 1988, $4,179 million in 1989, $4,291 million in 1990, and $4,764 million in 1991.

H. Tax Administration Provisions

1. Suspend Statute of Limitations During Prolonged Dispute Over Third-Party Records (Sec. 556 of the bill and sec. 7609 of the Code)

Present Law

There is generally a three-year statute of limitations on tax returns, except in cases of fraud, failure to file, or a sizeable understatement of income (sec. 6501). The statute continues to run even if the IRS must obtain records held by third parties.[13] If the IRS must litigate to obtain access to the third-party records, the statute of limitations can expire prior to final determination as to the availability of the records.

Reasons for Change

In general, IRS requests for access to third-party records are resolved relatively expeditiously. This is generally true because most third-party recordkeepers have no independent motivation to prolong the dispute with the IRS. In certain instances, however, a few third-party recordkeepers have prolonged these disputes with the IRS. Their motivation appears to have been to protect the interests of their clients by prolonging the litigation over the records sufficiently so that the statute of limitations expires during the dispute.

The committee believes that it is inappropriate for a third party to prolong litigation with the IRS so as to permit the statute of limitations to expire with respect to the taxpayer whose records are being sought. Consequently, the bill suspends the statute of limitations if the third party records are not produced within six months of the issuance of an administrative summons. The committee anticipates that this provision will rarely need to be utilized, since most disputes with third-party recordkeepers are resolved within six months of the issuance of an administrative summons.

Explanation of Provision

If the dispute between the third-party recordkeeper and the IRS is not resolved within six months after the IRS issues an administrative summons, the statute of limitations is suspended until the issue is resolved. The issue is not resolved during the pendency of any action to compel production of the documents. The third-party recordkeeper is also required to provide notice of the suspension of the statute of limitations to the taxpayer whose records are the subject of the dispute if the summons requesting the records does

[13] The statute is, however, suspended if the taxpayer intervenes in the dispute between the IRS and the third-party recordkeeper (sec. 7609(e)).

not identify the taxpayer by name. Failure by the third party to do so does not prevent the suspension of the statute.

Also, as is the case under current law, the statute of limitations is suspended during the period when a taxpayer intervenes in a dispute between the IRS and a third-party recordkeeper. The statute is suspended from that date until the entire dispute is resolved.

Effective Date

This provision is effective on the date of enactment of the bill.

2. Authority to Rescind Statutory Notice of Deficiency (Sec. 551 of the bill and sec. 6212 of the Code)

Present Law

Under present law, once the IRS has issued a statutory notice of deficiency (90-day letter), the IRS does not have the authority to withdraw the letter. The statutory notice is a jurisdictional prerequisite to petitioning the Tax Court for review of the IRS determination; the notice must be issued before the expiration of the statute of limitations. Once the notice has been issued, only a Tax Court decision can alter its effect.

Reasons for Change

In a number of cases, both the IRS and the taxpayer would prefer that the statutory notice be withdrawn so that the matter can be disposed of administratively without the involvement of the Tax Court. Therefore, the committee has determined that it is appropriate, where both the IRS and the taxpayer agree, to permit withdrawal of the statutory notice. This will permit the matter to be disposed of in the most efficient way.

Explanation of Provision

Where the IRS and the taxpayer mutually agree, a statutory notice of deficiency may be rescinded. Once the notice has been properly rescinded, it is treated as if it never existed. Therefore, limitations regarding credits, refunds, and assessments relating to the rescinded notice are void and the parties are returned to the rights and obligations existing prior to the issuance of the withdrawn notice. Also, the IRS may issue a later notice for a deficiency greater or less than the amount in the rescinded notice.

Under Code section 7805, the Secretary has the authority to establish by regulation the procedures necessary to implement the withdrawal of notice provision to assure that the taxpayer has consented to the withdrawal of the statutory notice. The regulations should also clarify the effect of rescission on other provisions of the Code.

Effective Date

This provision is effective for statutory notices of deficiency issued on or after the date of enactment.

3. Authority to Abate Interest Due to Errors or Delay by the IRS (Sec. 552 of the bill and sec. 6404 of the Code)

Present Law

Under present law, the IRS does not generally have the authority to abate interest charges where the additional interest has been caused by IRS errors and delays. This results from the IRS' long-established position that once tax liability is established, the amount of interest is merely a mathematical computation based on the rate of interest and due date of the return. Consequently, the interest portion of the amount owed to the Government cannot be reduced unless the underlying deficiency is reduced. The IRS does, however, have the authority to abate interest resulting from a mathematical error of an IRS employee who assists taxpayers in preparing their income tax returns (sec. 6404(d)).

Reasons for Change

In some cases, the IRS has admitted that its own errors or delays have caused taxpayers to incur additional interest charges. This may even occur after the underlying tax liability has been correctly adjusted by the IRS or admitted by the taxpayer. The committee believes that where an IRS official acting in his official capacity fails to perform a ministerial act, such as issuing either a statutory notice of deficiency or notice and demand for payment after all procedural and substantive preliminaries have been completed, authority should be available for the IRS to abate the interest independent of the underlying tax liability.

Explanation of Provision

In cases where an IRS official fails either to perform a ministerial act in a timely manner or makes an error in performing a ministerial act, the IRS has the authority to abate the interest attributable to such delay. No significant aspect of the delay can be attributable to the taxpayer. The bill gives the IRS the authority to abate interest but does not mandate that it do so (except that the IRS must do so in cases of certain erroneous refunds of less than $1 million, described below). The committee does not intend that this provision be used routinely to avoid payment of interest; rather, it intends that the provision be utilized in instances where failure to abate interest would be widely perceived as grossly unfair. The interest abatement only applies to the period of time attributable to the failure to perform the ministerial act.

The provision applies only to failures to perform ministerial acts that occur after the IRS has contacted the taxpayer in writing. This provision does not therefore permit the abatement of interest for the period of time between the date the taxpayer files a return and the date the IRS commences an audit, regardless of the length of that time period. Similarly, if a taxpayer files a return but does not pay the taxes due, this provision would not permit abatement of this interest regardless of how long the IRS took to contact the taxpayer and request payment.

The committee intends that the term "ministerial act" be limited to nondiscretionary acts where all of the preliminary prerequisites, such as conferencing and review by supervisors, have taken place. Thus, a ministerial act is a procedural action, not a decision in a substantive area of tax law. For example, a delay in the issuance of a statutory notice of deficiency after the IRS and the taxpayer have completed efforts to resolve the matter could be grounds for abatement of interest. The IRS may define a ministerial act in regulations.

Under its general authority to issue regulations, the IRS can issue regulations determining what constitutes timely performance of various ministerial acts called for by the Code.

The IRS must abate interest in certain instances in which it issues an erroneous refund check. For example, it has come to the committee's attention that the IRS may make an error that causes a taxpayer to get a refund check for $1,000 instead of the $100 that the taxpayer rightfully claimed. In the past, the IRS charged the taxpayer interest on the $900 for the time period that the taxpayer held that money.

The committee believes that it is inappropriate to charge taxpayers interest on money they temporarily have because the IRS has made an error. Consequently, the IRS may not charge interest on these erroneous refunds until the date it demands repayment of the money. The committee intends that two limitations be placed on this rule. First, it is not to apply in instances in which the taxpayer (or a related party) has in any way caused the overstated refund to occur. Second, it is not to apply to any erroneous refund checks that exceed $1 million. If the taxpayer does not repay the erroneous refund when requested to do so by the IRS, interest would then begin to apply to the amount of the erroneous refund.

Effective Date

This provision is effective for interest accruing with respect to deficiencies or payments for taxable years beginning in or after 1982. With respect to taxable years 1982, 1983, and 1984, the committee intends that taxpayers initiate a request that the IRS abate the interest and issue a refund. For taxable years following these years, the committee intends that the IRS abate interest in appropriate circumstances. Taxpayers may also request that the IRS abate interest.

4. Suspension of Compounding Where Interest on Deficiency Is Suspended (Sec. 553 of the bill and sec. 6601 of the Code)

Present Law

Under present law, in the case of a deficiency in income, estate, gift, and certain excise taxes, a waiver of restrictions on assessment of the deficiency is filed when the IRS and the taxpayer agree on the proper amount of tax due at the conclusion of an audit. If, however, the Secretary fails to make notice and demand for payment within 30 days after the filing of the waiver, interest is not imposed on the deficiency from the 31st day after the waiver was filed until the date the notice and demand is issued. The provision does not,

however, suspend the compounding of interest for the same period on the interest which previously accrued on the underlying deficiency.

Reasons for Change

The intent of the present law-provision is to suspend the running of interest where the IRS fails to issue the taxpayer a bill stating how much the taxpayer owes within 31 days of concluding an audit. The committee believes that it is appropriate to apply the same principle to the compounding of interest on previously accrued interest.

Explanation of Provision

Both the interest on the deficiency as well as the compounded interest on the previously accrued interest are suspended, starting 31 days after a taxpayer has filed a waiver of restrictions on assessment of the underlying taxes and ending when a notice and demand is issued to the taxpayer.

Effective Date

This provision is effective for interest accruing in taxable periods after December 31, 1982. Taxpayers may obtain refunds of interest subject to this provision that they paid by filing a claim for refund of their interest with the IRS. The IRS presently does not possess the data processing capability to suspend the compounding of interest on previously accrued interest. Taxpayers who consider themselves entitled to the relief provided by this provision may apply to the IRS, and, in appropriate cases, the IRS will perform the required computations manually.

5. Exemption from Levy For Service-Connected Disability Payments (Sec. 554 of the bill and sec. 6334 of the Code)

Present Law

Under present law, various payments, such as unemployment benefits, workmen's compensation, a minimum amount of ordinary wages, as well as certain pensions and annuities, are exempt from levy. This means that the IRS cannot seize these payments to collect delinquent taxes by serving a levy on the payment source. The IRS can collect the delinquent taxes from other nonexempt sources available to the delinquent taxpayer.

Reasons for Change

The committee believes that various military service-connected disability payments should be exempt from levy, just as other similar payments are exempt from levy.

Explanation of Provision

The IRS is prohibited from levying on any amount payable to an individual as a service-connected disability benefit under specified provisions of Title 38 of the United States Code.

The term "service-connected" means that the disability was incurred or aggravated in the line of duty in the active military, naval, or air service. The exemption covers direct compensation payments, as well as other types of support payments for education and housing.

Effective Date

This provision is effective for payments made after December 31, 1986.

6. Certain Recordkeeping Requirements (Sec. 555 of the bill)

Present Law

In general, law enforcement officers are not subject to the substantiation rules of section 274(d) and the income and wage inclusion rules of section 132 for specified use of a law enforcement vehicle. The conference report on the repeal of the contemporaneous recordkeeping requirements for automobiles[14] provided that IRS special agents are not to be included within the term "law enforcement officers."

Reasons for Change

The committee believes that it is appropriate to treat IRS special agents in the same manner as other law enforcement officers are treated.

Explanation of Provision

The bill provides that, for purposes of sections 132 and 274, use of an automobile by a special agent of the IRS is treated in the same manner as use of an automobile by an officer of any other law enforcement agency.

Effective Date

The provision is effective beginning after December 31, 1984.

7. Voluntary Disclosure Policy (Sec. 559 of the bill)

Present Law

Internal Revenue Service policy provides that voluntary disclosure by a taxpayer of the taxpayer's tax law violations is a factor that may be significant in determining whether the IRS will recommend criminal prosecution of the taxpayer (IR Manual, Criminal Investigation, P-9-2, approved August 20, 1979). This policy does not guarantee that a taxpayer who voluntarily discloses tax law violations will not be prosecuted.

Reasons for Change

The committee believes that a number of taxpayers would voluntarily disclose prior tax law violations if they were assured that

[14] H. Rept. 99-67 (May 7, 1985).

they would avoid all criminal penalties. The committee believes that it is important to return these taxpayers to the tax rolls, especially at a time of significant tax reform. The committee is also concerned that convictions for certain types of criminal activity (such as dealing in drugs or organized crime activities) are most successfully obtained for tax-related offenses. Consequently, the committee has given authority to the Treasury to exclude specified taxpayers from participating in this program.

Explanation of Provision

The bill provides that taxpayers who fully disclose voluntarily their previous violations of the tax laws are to be guaranteed immunity from criminal penalties for those offenses. Taxpayers must do so before they (or a related party) are given notice of an inquiry or investigation into their tax affairs. This notice may come from the IRS, another law enforcement agency, or another tax administration agency. The committee anticipates that Treasury will provide taxpayers with more detailed guidance as to what constitutes notice for purposes of this provision.

Treasury is given broad regulatory authority to issue regulations implementing this provision, including the authority to exclude specified categories of taxpayers from participating in this program. For example, the committee expects that these regulations will exclude participants in activities that are illegal under provisions other than the tax code (such as dealing in illegal drugs).

The bill also requires that IRS extensively publicize the scope and availability of this program. The IRS must do this by supplementing existing taxpayer service programs with a comprehensive publicity campaign describing this voluntary disclosure policy. The IRS must also conduct a public relations program to restore public confidence in the Federal tax system. The publicity campaign must include press releases, notices in IRS publications, and notices in other material sent to taxpayers.

Effective Date

This provision is effective on the date Treasury issues regulations implementing this provision. These regulations must be issued no later than January 1, 1987.

8. Disclosure of Return Information to Local Agencies (Sec. 557 of the bill and sec. 6103 of the Code)

Present Law

Section 6103 provides for the confidentiality of returns and return information of taxpayers. The conditions under which returns and return information can be disclosed are specifically enumerated in that section. Disclosure of returns and return information to local income tax administrators is not permitted. Unauthorized disclosure is a felony punishable by a fine not exceeding $5,000 or imprisonment of not more than 5 years, or both, under section 7213. An action for civil damages may also be brought for unauthorized disclosure under section 7431.

Reasons for Change

The committee would like to enable large cities that impose an income or wage tax to receive returns and return information in the same manner, and with the same safeguards, as States are eligible to do.

Explanation of Provision

The bill provides that any city with a population in excess of 2,000,000 that imposes an income or wage tax may, if the Secretary in his sole discretion [15] so provides, receive returns and return information for the same purposes for which States may obtain information under present law, subject to the same safeguards as apply to States under present law. Cities that receive information must reimburse the Internal Revenue Service for its costs in the same manner as a State must under present law. Population is determined on the basis of the most recent decennial United States census data available.

Any disclosure would be required to be in the same manner and with the same safeguards as disclosure is made to a State. The present-law requirements of maintaining a system of standardized requests for information and the reasons for the request and of maintaining strict security against release of the information are also made applicable to the local agencies. Disclosure will be permitted only for the purpose of, and only to the extent necessary in, the administration of a local jurisdiction tax. Disclosure of returns or return information to any elected official or the chief official (even if not elected) of the local jurisdiction will not be permitted. Any unauthorized disclosure of returns and return information by an employee of an agency receiving this information will subject the employee to the fine and imprisonment provided by section 7213 and to the civil action provided by section 7431.

Effective Date

This provision is effective on the date of enactment.

Revenue Effect of Tax Administration Provisions

These provisions are estimated to increase fiscal year budget receipts by $160 million in 1987 and by negligible amounts thereafter.

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[15] The Secretary may, in accordance with this discretion, implement this provision on a trial basis.

I. Modification of Withholding Schedules (Sec. 562 of the bill and sec. 3402 of the Code)

Present Law

The Code requires that the Secretary prescribe tables and computational procedures for determining the appropriate amount of taxes to be deducted and withheld from wages (sec. 3402(a)). Form W-4 is the form on which that calculation is done. It is completed by the employee, who furnishes it to the employer. The employer uses this form to determine the proper level of wage withholding. The employer does this by using tables issued by the Secretary that specify the proper amount of withholding, considering the employee's wage level and number of withholding allowances claimed.

The employee completes the Form W-4 by determining the proper number of withholding allowances (or exemptions) to which he is entitled. Withholding allowances may be claimed for the employee and any dependents (sec. 3402(f)) and for itemized deductions and estimated tax credits (sec. 3402(m)). Other items prescribed in regulations may also be claimed. For example, the regulations permit IRA contributions and the tax savings attributable to income averaging to be considered (see Treas. Reg. sec. 31.3402(m)-1). An employee's Form W-4 generally remains in effect until the employee revokes it and files a new one.[16]

The IRS has authority to issue regulations permitting employees to request, once the amount of their withholding has been determined on the basis of Form W-4 and the withholding tables, that that amount of withholding be increased or decreased. The IRS has long permitted taxpayers to request increases in withholding; the IRS has never permitted taxpayers to request decreases in withholding.

Reasons for Change

Other provisions of the bill affect the wage withholding system in two ways. First, the bill alters several of the provisions of the Code relating to itemized deductions, tax credits, and other items that may be considered in computing withholding allowances. Forms W-4 that claim withholding allowances with respect to any of these altered provisions are inaccurate. For example, a Form W-4 that claims allowances for income averaging (which is repealed elsewhere in the bill) is inaccurate, in that it claims excessive allowances.

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[16] The employer is required to furnish copies of certain Forms W-4 to the IRS, such as those that claim more than 14 allowances or that claim total exemption from withholding (where wages are above $200 per week). Treas. Reg. sec. 31.3402(f)(2)-1(g). The IRS examines these forms, and if it determines that a claim of withholding allowances cannot be justified, it notifies the employer to change the employee's withholding.

Second, the bill affects the tables issued by the Secretary that are used by employers to determine the proper amount of withholding. The bill affects these tables primarily by altering the tax rates and brackets.

The committee has consequently determined that, in light of the major modifications that are made in this bill to the entire income tax system, the wage withholding system needs to be modified. The committee believes that these major changes make it necessary for employees to file revised Forms W-4.

Explanation of Provision

The bill requires that employees file a revised Form W-4 by January 1, 1988. They must do so on a Form W-4 that has been revised by the IRS to reflect the changes in the Code made by this bill.[17] If an employee does not file a revised Form W-4 by that date, the employer must withhold income taxes as if the employee claimed one allowance (if the employer checked the "Single" box on the most recent Form W-4 that the employee filed) or two allowances (if the employee checked the "Married" box).

The bill also requires that the IRS and Treasury modify the withholding schedules under section 3402 to better approximate tax liability under the amendments made by the bill. The committee expects that this modification will affect at least two major items. First, Form W-4 will be modified. Second, the withholding tables used by employers to determine the proper amount of wage withholding will also be modified.

With respect to modifying Form W-4, the committee expects that the IRS will make every effort to notify taxpayers that Form W-4 has been modified and that taxpayers must file the modified form with their employers by January 1, 1988. In addition, the committee expects that the IRS will issue the revised Form W-4 well before that date, to minimize the inconvenience of filing new forms for both employers and employees.

The modified form and tables should be designed so that withholding from taxpayer's wages approximates as closely as possible the taxpayer's ultimate tax liability. While the committee recognizes that it is impossible to accomplish this goal with absolute precision in the case of each taxpayer, it is nonetheless vital to the integrity of the tax system that the amount withheld from wages closely match the taxpayer's ultimate tax liability. While the committee recognizes that substantial involuntary overwithholding is undesirable,[18] the committee also recognizes that substantial underwithholding creates significant collection and enforcement problems.

While the committee believes that the changes in the substantive tax law made by this bill will permit wage withholding to approximate tax liability more closely for many taxpayers, the committee believes that increased complexity in the current Form W-4 and wage withholding tables is not desirable, even if it were designed to

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[17] It is also permissible for employees to fulfill the requirements of this provision by filing on a substitute Form W-4, so long as that form has been revised to parallel the official form and the substitute form complies with all IRS requirements pertaining to substitute Forms W-4.

[18] A significant portion of overwithholding appears to be attributable to taxpayer preference.

permit withholding to approximate tax liability more closely. Consequently, neither Form W-4 nor the wage withholding tables is to be made more complex when they are revised in accordance with this provision of the bill.

The bill also repeals the provision of present law giving the IRS authority to issue regulations permitting employees to request decreases in withholding. The provision relating to increases in withholding is unaffected.

Effective Date

The provision requiring employees to file new Forms W-4 is effective for wages paid after December 31, 1987. The provision relating to decreases in withholding is effective on the date of enactment.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $1,307 million in 1988, $61 million in 1989, $177 million in 1990, and $195 million in 1991.

J. Report on the Return-Free System (Sec. 563 of the bill)

Present Law

Taxpayers are generally required to file a paper document as their individual income tax return for the taxable year. These forms are currently the Form 1040 ("the long form"), the Form 1040A ("the short form"), and the recently created 1040EZ. In addition, the IRS is experimenting with magnetic tape return filing which allows approved return preparers to volunteer to file individual tax returns that they prepare with the IRS in a magnetic tape format. The return preparer retains the paper version of the tax return.

Reasons for Change

The ever-increasing paperwork burden on the Interral Revenue Service, the improved capabilities of computerized data processing, and expanded information reporting suggest that it may be possible to develop a return-free system for individuals. This system would relieve eligible taxpayers of most of the burden and expense of return preparation. Also, it would significantly reduce the volume of tax returns filed with the IRS. Consequently, the committee believes that it is appropriate to study the possibility of implementing the return-free system, which was first proposed in the President's proposal.

Explanation of Provision

The committee does not believe that the return-free system set forth in the President's proposal is sufficiently developed for implementation at this time. The committee therefore decided to require a report from the IRS setting forth:

(1) the identification of classes of individuals who would be permitted to use a return-free system;

(2) how such a system would be phased in;

(3) what additional resources the IRS would need to carry out such a system; and

(4) the types of changes to the Internal Revenue Code which would inhibit or enhance the use of such a system.

The report is to be submitted within six months of the date of enactment to the Senate Committee on Finance and the House Committee on Ways and Means.

In addition, the committee believes that the IRS should consider conducting an in-house feasibility test using previously filed information returns and individual income tax returns to test the practicality of the proposed system.

A number of provisions of this bill provide that the Secretary of the Treasury or his delegate is to prescribe regulations. Notwith-

standing any of these references, it is contemplated that the Secretary or his delegate will, pending the prescribing of these regulations, issue guidance for taxpayers with respect to the changes made by this bill by issuing Revenue Procedures, Revenue Rulings, forms, or other publications.

Effective Date

The report is due six months after enactment of the bill.

TITLE VI—CORPORATE AND GENERAL BUSINESS TAXATION

A. General Corporate Provisions

1. Corporate Tax Rates (sec. 601 of the bill and sec. 11 of the Code)

Present Law

Corporate taxable income is subject to tax under a five-step graduated tax rate structure. The top corporate tax rate is 46 percent on taxable income over $100,000. The corporate taxable income brackets and tax rates are presented in the table, below.

PRESENT LAW CORPORATE TAX RATES

Taxable Income	*Tax Rate (percent)*
Not over $25,000	15
Over $25,000 but not over $50,000	18
Over $50,000 but not over $75,000	30
Over $75,000 but not over $100,000	40
Over $100,000	46

This schedule of corporate tax rates was enacted in the Economic Recovery Tax Act of 1981 (ERTA), effective for 1983 and later years. For 1982, the applicable rates were 16 percent for taxable income not over $25,000, and 19 percent for taxable income over $25,000 but not over $50,000. For taxable years after 1978 and before 1982, the rates were 17 percent and 20 percent, respectively, for the lowest two brackets.

An additional 5-percent corporate tax is imposed on a corporation's taxable income in excess of $1 million. The maximum additional tax is $20,250. This provision phases out the benefit of graduated rates for corporations with taxable between $1,000,000 and $1,405,000; corporations with taxable income in excess of $1,405,000, in effect, pay a flat tax at a 46-percent rate. This provision was enacted in the Deficit Reduction Act of 1984, effective for taxable years beginning after 1983.

Rules are provided in the Code to prevent the benefits of graduated rates from being proliferated through the use of multiple, commonly controlled corporations (secs. 1551, 1561-1564). Other statutory provisions attempt to limit the use of corporations to avoid individual tax rates. These are principally the accumulated

earnings tax (sec. 531 et seq.), the personal holding company tax (sec. 541 et seq.), and certain personal service corporation provisions (sec. 269A).

Reasons for Change

A principal objective of the bill is to reduce marginal tax rates on income earned by individuals and by corporations. Lower tax rates promote economic growth by increasing the rate of return on investment. Lower tax rates also improve the allocation of resources within the economy by reducing the impact of tax considerations on business and investments decisions. In addition, lower tax rates promote compliance by reducing the potential gain from engaging in transactions designed to avoid or evade income tax. Under the bill, the maximum corporate rate is reduced from 46 percent to 33 percent.

Although the committee believes that the graduated rate structure should be retained to encourage growth in small business, it feels that the benefit of the lower rates should be limited to smaller corporations. Accordingly, under the bill the benefit of the graduated rate structure is phased out beginning at $100,000 of taxable income as compared to $1 million under present law. In addition, the committee has simplified the present graduated rate structure for corporations by reducing the number of brackets from five to three.

Explanation of Provision

Under the bill tax would be imposed on corporations under the schedule shown in the following table.

CORPORATE TAX RATES IN COMMITTEE BILL

Taxable Income	*Tax Rate (percent)*
Not over $50,000	15
Over $50,000 but not over $75,000	25
Over $75,000	33

An additional 5-percent tax is imposed on a corporation's taxable income in excess of $100,000. The maximum additional tax is $11,000. This provision phases out the benefit of graduated rates for corporations with taxable income between $100,000 and $320,000; corporations with income in excess of $320,000, in effect, will pay a flat tax at a 33-percent rate.

Effective Date

The revised corporate tax rates are fully effective for taxable years beginning on or after July 1, 1987. Taxpayers having a taxable year that includes July 1, 1987, will be subject to a blended

rate that reflects the lower rate for the portion of their year after that date (see sec. 15).

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by $8,092 million in 1987, $22,880 million in 1988, $30,591 million in 1989, $32,564 million in 1990, and $33,854 million in 1991.

2. Dividends Received Deduction (sec. 611 of the bill and secs. 243-246A of the Code)

Present Law

Under present law, corporations that receive dividends generally are entitled to a deduction equal to 85 percent of the dividends received (sec. 243(a)(1)). Dividends received from a small business investment company operating under the Small Business Investment Act of 1958 (sec. 243(a)(2)), and "qualifying dividends" received from certain members of an affiliated group are eligible for a 100 percent dividends received deduction (sec. 243(a)(3)). In addition, pursuant to Treasury regulations, dividends received by one member of an affiliated group filing a consolidated return from another member of the group are not taxed currently to the recipient (Treas. Reg. sec. 1.1502-14).

There are exceptions for certain dividends received by a U.S. corporation from a foreign corporation and from certain other entities; and the deduction is limited in certain other circumstances.

Reasons for Change

Under present law, dividends eligible for the 85 percent dividends received deduction are taxed at a maximum rate of 6.9 percent (15 percent of the top corporate rate of 46 percent). The committee does not believe that the reduction in corporate tax rates generally should result in a significant reduction in this effective rate. Thus, the dividends received deduction has been reduced to 80 percent, resulting in a maximum rate of 6.6 percent on dividends subject to the reduced top corporate rate (20 percent of the top corporate rate of 33 percent).

Explanation of Provision

Under the committee bill, the 85 percent dividends received deduction is lowered to 80 percent.

Effective Date

The reduction in the dividends received deduction is applicable to dividends received or accrued after December 31, 1986 in taxable years ending after such date.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $139 million in 1987, $217 million in 1988, $218 million in 1989, $236 million in 1990, and $254 million in 1991.

3. Dividend Exclusion for Individuals (Sec. 612 of the bill and sec. 116 of the Code)

Present Law

Under present law, the first $100 of qualified dividends received by an individual shareholder ($200 by a married couple filing jointly) from domestic corporations is excluded from income (sec. 116(a)).

The dividend exclusion for individuals does not apply to dividends received from an organization that was exempt from tax under section 501 or a tax-exempt farmers' cooperative in either the year of distribution or the preceding year (sec. 116(b)(2)), dividends received from a mutual savings bank that received a deduction for the dividend under section 591 (sec. 116(c)(1)), or to an ESOP dividend for which the corporation received a deduction (sec. 116(e)). The exclusion is limited with respect to dividends received from a RIC (sec. 116(c)(2)).

Reasons for Change

The committee believes that the dividend exclusion for individuals under present law provides little relief from the two-tier corporate income tax because of the low limitation. As an exclusion from income, it also tends to benefit high-bracket taxpayers more than low-bracket taxpayers. On balance, the committee believes it is preferable to eliminate the exclusion and use the revenues to reduce tax rates.

Explanation of Provision

Under the committee bill, the dividend exclusion for individuals is repealed.

Effective Date

The provision is effective for taxable years beginning after December 31, 1986.

Revenue Effect

The provision is expected to increase fiscal year budget receipts by $228 million in 1987, $604 million in 1988, $607 million in 1989, $673 million in 1990, and $748 million in 1991.

4. Stock Redemption Payments (sec. 613 of the bill and section 162 of the Code)

Present Law

A deduction is allowed for all ordinary and necessary business expenses incurred during the taxable year in carrying on a trade or business (sec. 162(a)). A deduction is not allowed currently, however, for the costs of acquiring property whose life extends substantially beyond the close of the taxable year; such costs must be capitalized (sec. 263).

The purchase of stock, including the repurchase by an issuing corporation of its own stock, is generally treated as a capital trans-

action that does not give rise to a current deduction. One case suggests that, in extraordinary circumstances, amounts paid by a corporation to repurchase its stock may be deductible under section 162 in the year paid. In *Five Star Manufacturing Co.* v. *Comm'r*, 355 F.2d 724 (5th Cir. 1966), the court relied on the fact that liquidation of the corporation was imminent in the absence of the repurchase, and that no value would have been realized by the shareholders on such a liquidation, in upholding the deduction of the payments. Subsequent cases, however, have strictly limited the holding in *Five Star* to its peculiar facts,[1] or have questioned its validity.[2] These cases did not allow a deduction for stock redemption payments.

The Supreme Court has held that the requirement that stock redemption payments be capitalized extends not only to amounts representing consideration for the stock itself, but also to expenses such as legal, brokerage, and accounting fees incident to the acquisition.[3]

Reasons for Change

The committee understands that some corporate taxpayers are taking the position that expenditures incurred to repurchase stock from stockholders to prevent a hostile takeover of the corporation by such shareholders—so-called "greenmail" payments—are deductible business expenses. The committee wishes to provide expressly that all expenditures by a corporation incurred in purchasing its own stock, whether representing direct consideration for the stock, a premium payment above the apparent stock value, or costs incident to the purchase, are nonamortizable capital expenditures.

Explanation of Provision

The bill denies a deduction for any amount paid or incurred by a corporation in connection with the redemption of its stock. This provision is not limited to hostile takeover situations but applies to any corporate stock redemption. The committee intends that amounts subject to this provision will include amounts paid to repurchase stock; premiums paid for the stock; legal, accounting, brokerage, transfer agent, appraisal, and similar fees incurred in connection with the repurchase; and any other expenditure that is necessary or incident to the repurchase, whether representing costs incurred by the purchasing corporation or by the selling shareholder (and paid or reimbursed by the purchasing corporation), or incurred by persons or entities related to either. The provision is also intended to apply to any amount paid by a corporation to a selling shareholder (or any related person) pursuant to an agreement entered into as part of or in connection with a repurchase of stock,

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[1] See, e.g., *Jim Walter Corp.* v. *United States*, 498 F. 2d 631 (5th Cir. 1974); *Markham & Brown, Inc.* v. *United States*, 648 F.2d 1043 (5th Cir. 1981); *H. & G. Industries* v. *Comm'r*, 495 F.2d 653 (3d Cir. 1974); *Harder Services, Inc.* v. *Comm'r*, 67 T.C. 585 (1976), aff'd without opinion 573 F.2d 1290 (2d Cir. 1977).

[2] See, e.g., *Proskauer v. Comm'r*, 46 T.C.M. 679, 684 (1983), noting that the *Five Star* court may have applied the "primary purpose" standard that was often used in determining whether the expenditure was capital in nature before the Supreme Court's rejection of that standard in *Woodward* v. *Comm'r*, 397 U.S. 572 (1970).

[3] See *Woodward* v. *Comm'r*, supra; *United States* v. *Hilton Hotels Corp.*, 397 U.S. 580 (1970).

whereunder the seller agrees not to purchase, finance a purchase, acquire, or in any way be a party or agent to the acquisition of stock of the corporation for a specified or indefinite period of time (so-called "standstill" agreements).

The provision does not apply to interest deductible under section 163. In addition, it does not apply to amounts constituting dividends within the meaning of section 561, relating to payments (or deemed payments) for purposes of the accumulated earnings, personal holding company, and foreign personal holding company taxes, and for purposes of the regular income tax in the case of regulated investment companies and real estate investment trusts.[4] Thus, such amounts will continue to qualify for the dividends paid deduction to the same extent as under present law.

Further, the provision does not apply to otherwise deductible expenses incurred by a regulated investment company that is an open-end mutual fund in connection with the redemption of its stock upon the demand of a shareholder. Thus, for example, costs incurred by such a company in processing applications for redemption and issuing checks in payment for redeemed shares would be deductible to the same extent as under present law.[5]

In denying a deduction for payments in connection with redemptions of stock, the committee intends no inference regarding the deductibility of such payments under present law. Moreover, no inference is intended as to the character of such payments in the hands of the payee.

Effective Date

The provision is effective for amounts paid or incurred after February 28, 1986.

Revenue Effect

The provision is estimated to have no effect on fiscal year budget receipts.

5. Special Limitations on Net Operating Loss and Other Carryforwards (sec. 621 of the bill and secs. 382 and 383 of the Code)

Present Law

Overview

In general, a corporate taxpayer is allowed to carry a net operating loss ("NOL(s)") forward for deduction in a future taxable year, as long as the corporation's legal identity is maintained. After certain nontaxable asset acquisitions in which the acquired corporation goes out of existence, the acquired corporation's NOL carryforwards are inherited by the acquiring corporation. Similar rules apply to tax attributes other than NOLs, such as net capital losses and unused tax credits. Historically, the use of NOL and other carryforwards has been subject to special limitations after specified transactions involving the corporation in which the carryforwards

[4] See secs. 535, 545, 556, 852, 857.
[5] See Rev. Rul. 73-463, 1973-2 C.B. 34.

arose (referred to as the "loss corporation"). Present law also provides other rules that are intended to limit tax-motivated acquisitions of loss corporations.

Under present law, the operation of the special limitations on the use of carryforwards turns on whether the transaction that causes the limitations to apply takes the form of a taxable sale or exchange of stock in the loss corporation or one of certain specified tax-free reorganizations in which the loss corporation's tax attributes carry over to a corporate successor. After a purchase (or other taxable acquisition) of a controlling stock interest in a loss corporation, NOL and other carryforwards are disallowed unless the loss corporation continues to conduct its historic trade or business. In the case of a tax-free reorganization, NOL and other carryforwards are generally allowed in full if the loss corporation's shareholders receive stock representing at least 20 percent of the value of the acquiring corporation.

NOL and other carryforwards

Although the Federal income tax system generally requires an annual accounting, a corporate taxpayer is allowed to carry NOLs back to the three taxable years preceding the loss and then forward to each of the 15 taxable years following the loss year (sec. 172). The rationale for allowing the deduction of NOL carryforwards (and carrybacks) is that a taxpayer should be able to average income and losses over a period of years to reduce the disparity between the taxation of businesses that have stable income and businesses that experience fluctuations in income.[6]

In addition to NOLs, other tax attributes eligible to be carried back or forward include unused investment tax credits (secs. 30 and 39), excess foreign tax credits (sec. 904(c)), and net capital losses (sec. 1212). Like NOLs, unused investment tax credits are allowed a three-year carryback and a 15-year carryforward. Subject to an overall limitation based on a taxpayer's U.S. tax attributable to foreign-source income, excess foreign tax credits are allowed a two-year carryback and a five-year carryforward. For net capital losses, generally, corporations have a three-year carryback (but only to the extent the carrybacks do not increase or create a NOL) and a five-year carryforward.

NOL and other carryforwards that are not used before the end of a carryforward period expire.

Carryovers to corporate successors

In general, a corporation's tax history (e.g., carryforwards and asset basis) is preserved as long as the corporation's legal identity is continued. Thus, under the general rules of present law, changes in the stock ownership of a corporation do not affect the corporation's tax attributes. Following are examples of transactions that effect ownership changes without altering the legal identity of a corporation:

(1) A taxable purchase of a corporation's stock from its shareholders (a "purchase"),

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[6] H.R. Rep. No. 1337, 83d Cong., 2d sess. 27 (1954).

(2) A type "B" reorganization, in which stock representing control of the acquired corporation is acquired solely in exchange for voting stock of the acquiring corporation (or a corporation in control of the acquiring corporation) (sec. 368(a)(1)(B)),

(3) A transfer of property to a corporation after which the transferors own 80 percent or more of the corporation's stock (a "section 351 exchange"),

(4) A contribution to the capital of a corporation, in exchange for the issuance of stock, and

(5) A type "E" reorganization, in which interests of investors (shareholders and bondholders) are restructured (sec. 368(a)(1)(E)).

Statutory rules also provide for the carry over of tax attributes (including NOL and other carryforwards) from one corporation to another in certain tax-free acquisitions in which the acquired corporation goes out of existence (sec. 381). These rules apply if a corporation's assets are acquired by another corporation in one of the following transactions:

(1) The liquidation of an 80-percent owned subsidiary (sec. 332),

(2) A statutory merger or consolidation, or type "A" reorganization (sec. 368(a)(1)(A)),

(3) A type "C" reorganization, in which substantially all of the assets of one corporation is transferred to another corporation in exchange for voting stock, and the transferor completely liquidates (sec. 368(a)(1)(C)),

(4) A "nondivisive D reorganization," in which substantially all of a corporation's assets are transferred to a controlled corporation, and the transferor completely liquidates (secs. 368(a)(1)(D) and 354(b)(1)),

(5) A mere change in identity, form, or place of organization of a single corporation, or type "F" reorganization (sec. 368(a)(1)(F)), and

(6) A type "G" reorganization, in which substantially all of a corporation's assets are transferred to another corporation pursuant to a court approved insolvency or bankruptcy reorganization plan, and stock or securities of the transferee are distributed pursuant to the plan (sec. 368(a)(1)(G)).

In general, to qualify an acquisitive transaction (including a B reorganization) as a tax-free reorganization, the shareholders of the acquired corporation must retain "continuity of interest." Thus, a principal part of the consideration used by the acquiring corporation must consist of stock, and the holdings of all shareholders must be traced. Further, a tax-free reorganization must satisfy a "continuity of business enterprise" test. Generally, continuity of business enterprise requires that a significant portion of an acquired corporation's assets be used in a business activity (see Treas. reg. sec. 1.368-1(d)).

Acquisitions to evade or avoid income tax

The Secretary of the Treasury is authorized to disallow deductions, credits, or other allowances following an acquisition of control of a corporation or a tax-free acquisition of a corporation's assets if the principal purpose of the acquisition was tax avoidance (sec. 269). This provision applies in the following cases:

(1) where any person or persons acquire (by purchase or in a tax-free transaction) at least 50 percent of a corporation's voting stock,

or stock representing 50 percent of the value of the corporation's outstanding stock;

(2) where a corporation acquires property from a previously unrelated corporation and the acquiring corporation's basis for the property is determined by reference to the transferor's basis; and

(3) where a corporation purchases the stock of another corporation in a transaction that qualifies for elective treatment as a direct asset purchase (sec. 338), a section 338 election is not made, and the acquired corporation is liquidated into the acquiring corporation (under sec. 332).

Treasury regulations under section 269 provide that the acquisition of assets with an aggregate basis that is materially greater than their value (i.e., assets with built-in losses), coupled with the utilization of the basis to create tax-reducing losses, is indicative of a tax-avoidance motive (Treas. reg. sec. 1.269-3(c)(1)).

Consolidated return regulations

To the extent that NOL carryforwards are not limited by the application of section 382 or section 269, after an acquisition, the use of such losses may be limited under the consolidated return regulations. In general, if an acquired corporation joins the acquiring corporation in the filing of a consolidated tax return by an affiliated group of corporations, the use of the acquired corporation's pre-acquisition NOL carryforwards against income generated by other members of the group is limited by the "separate return limitation year" ("SRLY") rules (Treas. reg. sec. 1.1502-21(c)). An acquired corporation is permitted to use pre-acquisition NOLs only up to the amount of its own contribution to the consolidated group's taxable income. Section 269 is available to prevent taxpayers from avoiding the SRLY rules by diverting income-producing activities (or contributing income-producing assets) from elsewhere in the group to a newly acquired corporation (see Treas. reg. sec. 1.269-3(c)(2), to the effect that the transfer of income-producing assets by a parent corporation to a loss subsidiary filing a separate return may be deemed to have tax avoidance as a principal purpose).

Applicable Treasury regulations provide rules to prevent taxpayers from circumventing the SRLY rules by structuring a transaction as a "reverse acquisition" (defined in regulations as an acquisition where the "acquired" corporation's shareholders end up owning more than 50 percent of the value of the "acquiring" corporation) (Treas. reg. sec. 1.1502-75(d)(3)). Similarly, under the "consolidated return change of ownership" ("CRCO") rules, if more than 50 percent of the value of stock in the common parent of an affiliated group changes hands, tax attributes (such as NOL carryforwards) of the group are limited to use against post-acquisition income of the members of the group (Treas. reg. sec. 1.1502-21(d)).

Treasury regulations also prohibit the use of an acquired corporation's built-in losses to reduce the taxable income of other members of an affiliated group (Treas. reg. sec. 1.1502-15). Under the regulations, built-in losses are subject to the SRLY rules. In general, built-in losses are defined as deductions or losses that economically accrued prior to the acquisition but are recognized for tax purposes after the acquisition, including depreciation deductions attributable to a built-in loss (Treas. reg. sec. 1.1502-15(a)(2)). The

built-in loss limitations do not apply unless, among other things, the aggregate basis of the acquired corporation's assets (other than cash, marketable securities, and goodwill) exceeds the value of those assets by more than 15 percent.

Allocation of income and deductions among related taxpayers

The Secretary of the Treasury is authorized to apportion or allocate gross income, deductions, credits, or allowances, between or among related taxpayers (including corporations), if such action is necessary to prevent evasion of tax or clearly reflect the income of a taxpayer (sec. 482). Section 482 can apply to prevent the diversion of income to a loss corporation in order to absorb NOL carryforwards.

Libson Shops doctrine

In *Libson Shops v. Koehler*, 353 U.S. 382 (1957) (decided under the 1939 Code), the U.S. Supreme Court adopted a test of business continuity for use in determining the availability of NOL carryovers. The court denied NOL carryovers following the merger of 16 identically owned corporations (engaged in the same business at different locations) into one corporation, on the grounds that the business generating post-merger income was not substantially the same business that incurred the loss (three corporations that generated the NOL carryovers continued to produce losses after the merger).

There is uncertainty whether the *Libson Shops* doctrine has continuing application as a separate nonstatutory test under the 1954 Code. Compare *Maxwell Hardware Co. v. Commissioner*, 343 F.2d 713 (9th Cir. 1965) (holding that *Libson Shops* is inapplicable to years governed by the 1954 Code) with Rev. Rul. 63-40, 1963-1 C.B. 46, as modified by T.I.R. 773 (October 13, 1965) (indicating that *Libson Shops* may have continuing vitality where, inter alia, there is a shift in the "benefits" of an NOL carryover).[7]

1954 Code special limitations

The application of the special limitations on NOL carryforwards is triggered under the 1954 Code by specified changes in stock ownership of the loss corporation (sec. 382). In measuring changes in stock ownership, section 382(c) specifically excludes "nonvoting stock which is limited and preferred as to dividends." Different rules are provided for the application of special limitations on the use of carryovers after a purchase and after a tax-free reorganization. Section 382 does not address the treatment of built-in losses.

If the principal purpose of the acquisition of a loss corporation is tax avoidance, section 269 could apply to disallow NOL carryforwards even if section 382 is inapplicable. Similarly, the SRLY rules could apply even if section 382 does not apply.

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[7] The legislative history of the 1976 Act amendments to section 382—discussed below—specifically provides that *Libson Shops* has no application to years governed by these amendments. See S. Rep. No. 938, 94th Cong., 2d Sess. p. 206 (1976).

Taxable purchases

If the special limitations apply after a purchase, NOL carryforwards are disallowed entirely under the 1954 Code. The rule for purchases applies if (1) one or more of the loss corporation's ten largest shareholders increase their common stock ownership within a two-year period by more than 50 percentage points, (2) the change in stock ownership results from a purchase or a decrease in the amount of outstanding stock, and (3) the loss corporation fails to continue the conduct of a trade or business substantially the same as that conducted before the proscribed change in ownership (sec. 382(a)). An exception to the purchase rule is provided for acquisitions from related persons.

Tax-free reorganizations

After a tax-free reorganization to which section 382(b) applies, NOL carryovers are allowed in full under the 1954 Code so long as the loss corporation's shareholders receive stock representing 20 percent or more of the value of the successor corporation (and section 269 does not apply). For each percentage point less than 20 percent received by the loss corporation's shareholders, the NOL carryover is reduced by five percent (e.g., if the loss corporation's shareholders receive 15 percent of the acquiring corporation's stock, 25 percent of the NOL carryover is disallowed). The reorganizations described in section 382(b) are those referred to in section 381(a)(2), in which the loss corporation goes out of existence and NOL carryforwards carry over to a corporate successor. Where an acquiring corporation uses stock of a parent corporation as consideration (in a triangular reorganization), the 20-percent test is applied by treating the loss corporation's shareholders as if they received stock of the acquiring corporation with an equivalent value, rather than stock of the parent corporation. An exception to the reorganization rule is provided for mergers of corporations that are owned substantially by the same persons in the same proportion (thus, the result in the *Libson Shops* case is reversed).

Bankruptcy proceedings and stock-for-debt exchanges

In the case of a G reorganization, a creditor who receives stock in the reorganization is treated as a shareholder immediately before the reorganization. Thus, NOL carryforwards are generally available without limitation following changes in stock ownership resulting from a G reorganization.

If security holders exchange securities for stock in a loss corporation, the transaction could qualify as an E reorganization or a section 351 exchange. If unsecured creditors (e.g., trade creditors) exchange their debt claims for stock in a loss corporation, such creditors recognize gain or loss: (1) indebtedness of the transferee corporation not evidenced by a security is not considered as issued for property for purposes of section 351, and (2) the definition of an E reorganization requires an exchange involving stock or securities. Thus, a stock-for-debt exchange by unsecured creditors is treated as a taxable purchase that triggers the special limitation.

Transactions involving "thrifts"

The general rules apply to taxable purchases of stock in a savings and loan association or savings bank (referred to as a "thrift"). Thus, after an ownership change resulting from a taxable purchase, a thrift's NOL carryforwards are unaffected if the thrift continues its business. Moreover, section 382 does not apply to a section 351 transfer to a thrift.

Where the acquisition of a thrift results from a reorganization described in section 368(a)(3)(D)(ii),[8] depositors are treated as stockholders and their deposits are treated for purposes of the special limitations applicable to reorganizations (sec. 382(b)(7)). Thus, a thrift's NOL carryforwards are unaffected if the depositors' interests (including the face amount of their deposits) represent at least 20 percent of the acquiring corporation's value after the merger.

Special limitations on other tax attributes

Section 383 incorporates by reference the same limitations contained in section 382 for carryforwards of investment credits, foreign tax credits, and capital losses.

1976 Act amendments

The Tax Reform Act of 1976 extensively revised section 382 to provide more nearly parallel rules for taxable purchases and tax-free reorganizations and to address technical problems under present law. The 1976 Act amendments were to be effective in 1978; however, the effective date was delayed several times. The 1976 Act amendments to the rule for purchases technically became effective for taxable years beginning after December 31, 1985. The amended reorganization rules technically became effective for reorganizations pursuant to plans adopted on or after January 1, 1986.

Reasons for Change

The committee bill draws heavily from the recommendations regarding limitations on NOL carryforwards that were made by the Finance Committee Staff as part of its comprehensive final report regarding reform of subchapter C of the Internal Revenue Code. (*See* S. Prt. 99-47, 99th Cong., 1st session (1985), "The Subchapter C Revision Act of 1985, A Final Report Prepared by the Staff").

Preservation of the averaging function of carryovers

The primary purpose of the special limitations is the preservation of the integrity of the carryover provisions. The carryover provisions perform a needed averaging function when they smooth out the distortions caused by the annual accounting system. If, on the other hand, carryovers can be transferred in a way that permits a loss to offset unrelated income, no legitimate averaging function is performed. With completely free transferability of tax losses, the carryover provisions become a mechanism for partial recoupment

[8] Sec. 368(a)(3)(D)(ii) provides nonrecognition treatment to thrift reorganizations that would otherwise qualify as G reorganizations, provided the Federal Home Loan Bank Board, the Federal Savings and Loan Insurance Corporation ("FSLIC"), or an equivalent State authority certifies that the thrift is insolvent, cannot meet its obligations currently, or will be unable to meet its obligations in the immediate future.

of losses through the tax system. Under such a system, the Federal Government would effectively be required to reimburse a portion of all corporate tax losses. Regardless of the merits of such a reimbursement program, the carryover rules appear to be an inappropriate and inefficient mechanism for delivery of the reimbursement.

Appropriate matching of loss to income

The 1976 Act limitations reflect the view that the relationship of one year's loss to another year's income should be largely a function of whether and how much the stock ownership changed in the interim, while the *Libson Shops* business continuation rule measures the relationship according to whether the loss and the income were generated by the same business. The bill acknowledges the merit in both approaches, while seeking to avoid the economic distortions and administrative problems that a strict application of either approach would entail.

A limitation based strictly on ownership would create a tax bias against sales of corporate businesses, and could prevent sales that would increase economic efficiency. For example, if a prospective buyer could increase the income from a corporate business to a moderate extent, but not enough to overcome the loss of all carryovers, no sale would take place because the business would be worth more to the less-efficient current owner than the prospective buyer would reasonably pay. A strict ownership limitation also would distort the measurement of taxable income generated by capital assets purchased before the corporation was acquired, if the tax deductions for capital costs economically allocable to post-acquisition years were accelerated into pre-acquisition years, creating carryovers that would be lost as a result of the acquisition.

Strict application of a business continuation rule would also be undesirable, because it would discourage efforts to rehabilitate troubled businesses. Such a rule would create an incentive to retain obsolete and inefficient business practices if the needed changes would create the risk of discontinuing the old business for tax purposes, thus losing the benefit of the carryovers.

Permitting the carryover of all losses following an acquisition, as is permitted under the 1954 Code if the loss business is continued following a purchase, provides an improper matching of income and loss. Income generated under different corporate owners, from capital over and above the capital used in the loss business, is related to a pre-acquisition loss only in the formal sense that it is housed in the same corporate entity. Furthermore, the ability to use acquired losses against such unrelated income creates a tax bias in favor of acquisitions. For example, a prospective buyer of a loss corporation might be a less efficient operator of the business than the current owner, but the ability could make the loss corporation more valuable to the less efficient user and thereby encourage a sale.

Reflecting the policies described above, the committee bill addresses three general concerns: (1) the approach of present law (viz., the disallowance or reduction of NOL and other carryforwards), which is criticized as being too harsh where there are continuing loss-corporation shareholders, and ineffective to the extent

that NOL carryforwards may be available for use without limitation after substantial ownership changes, (2) the discontinuities in the present law treatment of taxable purchases and tax-free reorganizations, and (3) defects in the existing rules that present opportunities for tax avoidance.

General approach

After reviewing various options for identifying events that present the opportunity for a tax benefit transfer (*e.g.*, changes in a loss corporation's business), the committee concluded that changes in a loss corporation's stock ownership continue to be the best indicator of a potentially abusive transaction. Under the bill, the special limitations generally apply when shareholders who bore the economic burden of a corporation's NOLs no longer hold a controlling interest in the corporation. In such a case, the possibility arises that new shareholders will contribute income-producing assets (or divert income opportunities) to the loss corporation, and the corporation will obtain greater utilization of carryforwards than it could have had there been no change in ownership.

To address the concerns described above, the committee adopted the following approach: After a substantial ownership change, rather than reducing the NOL carryforward itself, the earnings against which an NOL carryforward can be deducted are limited. This general approach adopted by the committee has received wide acceptance among tax scholars and practitioners. This "limitation on earnings" approach is intended to permit the survival of NOL carryforwards after an acquisition, while limiting the ability to utilize the carryforwards against another taxpayer's income.

The limitation on earnings approach is intended to approximate the results that would occur if a loss corporation's assets were combined with those of a profitable corporation in a partnership. This treatment can be justified on the ground that the option of contributing assets to a partnership is available to a loss corporation. In such a case, only the loss corporation's share of the partnership's income could be offset by the corporation's NOL carryforward. Presumably, except in the case of tax-motivated partnership agreements, the loss corporation's share of the partnership's income would be limited to earnings generated by the assets contributed by the loss corporation.

For purposes of determining the income attributable to a loss corporation's assets, the bill prescribes an objective rate of return on the value of the corporation's equity. The committee was informed of the arguments made in favor of computing the prescribed rate of return by reference to the gross value of a loss corporation's assets, without regard to outstanding debt. The committee concluded that it would be inappropriate to permit the use of NOL carryforwards to shelter earnings that are used (or would be used in the absence of an acquisition) to service a loss corporation's debt. Because interest paid on indebtedness is deductible in its own right (thereby deferring the use of a corresponding amount of NOLs), the effect of taking a loss corporation's gross value into account would be to accelerate the rate at which NOL carryforwards would be used had there been no change in ownership. Further, there is a fundamental difference between debt capitalization and

equity capitalization: true debt represents a claim against a loss corporation's assets.

Annual limitation

The annual limitation on the use of pre-acquisition NOL carryforwards is the product of the prescribed rate and the value of the loss corporation's equity immediately before a proscribed ownership change. The committee selected the average yield for mid-term marketable obligations of the U.S. government as the measure of a loss corporation's expected return on its assets.

The committee recognizes that the rate prescribed by the bill is higher than the average rate at which loss corporations actually absorb NOL carryforwards. Indeed, many loss corporations continue to experience NOLs, thereby increasing—rather than absorbing—NOL carryforwards. On the other hand, the adoption of the average absorption rate may be too restrictive for loss corporations that out-perform the average. Therefore, it would be inappropriate to set a rate at the lowest rate that is theoretically justified. The committee concluded that the use of the mid-term rate for Federal obligations was justified as a reasonable risk-free rate of return a loss corporation could obtain in the absence of a change in ownership.

Anti-abuse rules

The committee realized that the mechanical rules described above could present unintended tax-planning opportunities and might foster certain transactions that many would perceive to be violative of the committee's intent. Therefore, the committee adopted several rules that are intended to prevent taxpayers from circumventing the special limitations or otherwise appearing to traffic in loss corporations by (1) reducing a loss corporation's assets to cash or other passive assets and then selling off a corporate shell consisting primarily of NOLs and cash or other passive assets, or (2) making pre-acquisition infusions of assets to inflate artificially a loss corporation's value (and thereby accelerate the use of NOL carryforwards). In addition, the committee bill retains the present law rules that are intended to limit tax-motivated acquisitions of loss corporations (*e.g.*, section 269, relating to acquisitions to evade or avoid taxes, and the regulatory SRLY and CRCO rules).

The committee was also made aware of transactions in which taxpayers effectively attempt to purchase the NOLs of a loss corporation by the use of a partnership in which the loss corporation, as a partner, is allocated a large percentage of taxable income for a limited time period. During this time, the NOL partner's losses are expected to shelter the partnership's income while the cash flow from the partnership's assets is used for other purposes. Later the NOL partner's share of income is reduced. When all the facts and circumstances are considered, including the arrangements and actual transactions with respect to capital accounts, it often appears to be questionable whether the economic benefit that corresponds to the initial special allocation to the NOL partner is fully received by such partner. The committee understands that some taxpayers nevertheless take the position that such allocations have

substantial economic effect under section 704(b). The committee expects the Treasury Department to review this situation.

The bill provides that the Treasury Department shall prescribe such regulations as may be necessary or appropriate to prevent the avoidance of the bill's purposes through the use of related parties, pass-through entities, or other intermediaries. For example, regardless of whether a special allocation has substantial economic effect under section 704(b), the committee intends that special allocations of income to a loss partner, or other arrangements shifting taxable income, will not be permitted to result in a greater use of losses than would occur if the principles of section 382 were applied to the arrangement.

Technical problems

The committee bill addresses the technical problems of present law by (1) coordinating the rules for taxable purchases with the rules for tax-free transactions, (2) expanding the scope of the rules to cover economically similar transactions that effect ownership changes (such as capital contributions, section 351 exchanges, and B reorganizations), (3) refining the definition of the term "stock," and (4) applying the special limitations to built-in losses and taking into account built-in gains.

Discontinuities

Because the 1954 Code threshold for purchases is 50 percent, but the threshold for reorganizations is 20 percent, those rules present the possibility that economically similar transactions will receive disparate tax treatment. Further, the special limitations apply after a purchase only if a pre-acquisition trade or business is discontinued, while the reorganization rule looks solely to changes in ownership. Finally, if the purchase rule applies, all NOL carryforwards are disallowed. In contrast, the rule for reorganizations merely reduces NOL carryforwards in proportion to the ownership change. The committee bill attempts to eliminate such discontinuities.

Continuity-of-business enterprise

The requirement under the 1954 Code rules that a loss corporation continue substantially the same business after a purchase presents potentially difficult definitional issues. Specifically, taxpayers and the courts are required to determine at what point a change in merchandise, location, size, or the use of assets should be treated as a change in the loss corporation's business. It is also difficult to identify a particular business where assets and activities are constantly combined, separated, or rearranged. Further, there is a concern that the present law requirement may induce taxpayers to continue uneconomic businesses.

The committee bill eliminates the existing business-continuation rule. The continuity-of-business-enterprise rule generally applicable to tax-free reorganizations continues to apply to such transactions.

Participating stock

The bill addresses the treatment of transactions in which the beneficial ownership of an NOL carryforward does not follow stock

ownership. This problem is illustrated by the case of *Maxwell Hardware Co.*, in which a loss corporation's old shareholders retained common stock representing more than 50 percent of the corporation's value, but new shareholders received specially tailored preferred stock that carried with it a 90-percent participation in the corporation's earnings attributable to income-producing assets contributed by the new shareholders.[9] To address the problem, the bill defines stock to exclude stock that does not participate in a corporation's growth to any significant extent.

Built-in gains and losses

The committee concluded that built-in losses should be subject to special limitations because they are economically equivalent to pre-acquisition NOL carryforwards. If built-in losses were not subject to limitations, taxpayers could reduce or eliminate the impact of the general rules by causing a loss corporation (following an ownership change) to recognize its built-in losses free of the special limitations (and then investing the proceeds in assets similar to the assets sold).

The committee bill also provides relief for loss corporation having built-in gain assets. Built-in gains are often the product of special tax provisions that accelerate deductions or defer income (*e.g.*, accelerated depreciation or installment sales reporting). Absent a special rule, the use of NOL carryforwards to offset built-in gains recognized after an acquisition would be limited, even though the carryforwards would have been fully available to offset such gains had the gains been recognized before the change in ownership occurred. (Similarly, a partnership is required to allocate built-in gain or loss to the contributing partner.)

Although the special treatment of built-in gains and losses may require valuations of a loss corporation's assets, the bill limits the circumstances in which valuations will be required by providing a generous de minimis rule.

Other technical gaps

The committee's bill also corrects the following defects in the 1954 Code rules: (1) only NOL deductions from prior taxable years are limited; thus, NOLs incurred in the year of a substantial ownership change are unaffected, (2) the rule for purchases is inapplicable to ownership changes resulting from section 351 exchanges, capital contributions, the liquidation of a partner's interest in a partnership that owns stock in a loss corporation, and nontaxable acquisitions of interests in a partnership (*e.g.*, by contribution) that owns stock in a loss corporation, (3) the reorganization rule is inapplicable to B reorganizations, (4) the measurement of the continuing interest of a loss corporation's shareholders after a triangular reorganization enables taxpayers to circumvent the 20-percent-continuity-of-interest rule, and (5) taxpayers take the position that the reorganization rule does not apply to reverse mergers (where an acquiring corporation's subsidiary merges into a loss corporation and

[9] 343 F.2d 713 (9th Cir. 1965).

the loss corporation's shareholders receive stock of the acquiring corporation in the exchange).

Insolvent corporations

Under the general rule of the committee's bill, no carryforwards would survive the acquisition of an insolvent corporation because the corporation's value immediately before the acquisition would be zero. In such a case, however, the loss corporation's creditors are the true owners of the corporation, although it may be impossible to identify the point in time when ownership shifted from the corporation's shareholders.[10] The committee concluded that relief from a strict application of the general rule should be provided, as the creditors of an insolvent corporation frequently have borne the losses reflected in an NOL carryforward. The committee was concerned, however, about the potential for abusive transactions if an exception were generally available. For example, if there were a general stock-for-debt exception, an acquiring corporation could purchase a loss corporation's debt immediately before or during a bankruptcy proceeding, exchange the debt for stock without triggering the special limitations, and then use the loss corporation's NOL carryforwards immediately and without limitation. Alternatively, an acquiring corporation could purchase stock from the creditors after the bankruptcy proceeding, and after the loss corporation's value has been increased by capital contributions.

For these reasons, the bill provides an exception for ownership changes that occur as part of a G reorganization or a stock-for-debt exchange in a Title 11 or similar proceeding, but includes appropriate safeguards intended to limit tax-motivated acquisitions of debt issued by loss corporations.

Explanation of Provisions

Overview

The bill alters the character of the special limitations on the use of NOL carryforwards. After an ownership change of more than 50 percent of the value of a loss corporation, however effected, the taxable income available for offset by pre-change NOLs is limited to a prescribed rate times the value of the loss corporation immediately before the ownership change. The bill also expands the scope of the special limitations to include built-in losses and takes into account built-in gains. The bill includes other changes, of a more technical nature, including rules relating to the measurement of beneficial ownership. The bill applies similar rules to carryforwards other than NOLs, such as net capital losses and excess foreign tax credits.

Ownership changes

Under the bill, the special limitations apply after an ownership change. An ownership change occurs if there is an "owner shift" of

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[10] *Cf. Helvering v. Alabama Asphaltic Limestone Co.*, 315 U.S. 179 (1942) ("When the equity owners are excluded and the old creditors become the stockholders . . ., it conforms to reality to date [the creditors] equity ownership from the time when they invoked the processes of the law to enforce their rights of full priority").

more than 50 percent or an "equity structure change" of more than 50 percent during a three-year testing period.

Determinations of the percentage of stock in a corporation held by any person are made on the basis of value. Under regulations to be prescribed by the Secretary, changes in proportionate ownership attributable solely to fluctuations in the relative fair market values of different classes or amounts of stock are not taken into account.

In determining whether an ownership change has occurred, changes in the holdings of certain preferred stock are disregarded. Thus, all "stock" (other than stock described in section 1504(a)(4), relating to stock that is excluded in determining whether corporations are affiliated) is taken into account. Under this standard, the stock to be disregarded is stock that (1) is not entitled to vote, (2) is limited and preferred as to dividends and does not participate in corporate growth to any significant extent, (3) has redemption and liquidation rights that do not exceed the stock's issue price upon issuance (except for a reasonable redemption premium), and (4) is not convertible to any other class of stock.[11] Under this rule, preferred stock carrying a dividend rate materially in excess of a market rate when issued would not be disregarded. The bill authorizes the Secretary to prescribe such regulations as may be necessary to treat warrants, the conversion feature of convertible debt, and similar interests as stock.

Owner shift

An "owner shift" is defined to include any change in the holdings of stock in a corporation that is owned by "five-percent shareholders" either before or after the change. For purposes of this rule, the term "five-percent shareholder" is defined as any person holding five percent or more in value of the stock of a corporation at any time during the testing period. Examples of transactions that effect owner shifts include the following:

(1) A purchase of stock in a loss corporation from an existing shareholder or from the corporation itself;

(2) A section 351 exchange (i.e., a transfer of property to a loss corporation after which the transferor(s) owns 80 percent or more of the corporation's stock, or the transfer of stock in a loss corporation to another corporation in an exchange to which section 351 applies);

(3) A decrease in the total outstanding stock of a loss corporation (including changes effected by a redemption from other shareholders);

(4) An increase in the total outstanding stock of a loss corporation (including changes effected by the issuance of new stock or contributions to the capital of a loss corporation);

(5) The conversion of nonparticipating stock to participating stock; and

(6) Any combination of the foregoing.

An owner shift of more than 50 percent occurs if, immediately after an owner shift, the percentage of a loss corporation's stock

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[11] The committee intends that stock having the characteristics of the stock issued to the loss corporation shareholders in *Maxwell Hardware Co. v. Commissioner*, 343 F. 2d 713 (9th Cir. 1965), would not qualify under this standard.

(determined by value) that is held by one or more shareholders is more than 50 percentage points more or less than the holdings by such shareholders at any time during the three-year period preceding the owner shift (referred to as the "testing period"). The determination of whether a more than 50-percent owner shift has occurred is made by aggregating the increases or decreases in ownership for each shareholder. In determining whether a more than 50-percent owner shift has occurred following an owner shift, as described more fully below, prior equity structure changes and owner shifts are taken into account. Purchases or other transactions among less than five percent shareholders (except prior equity structure changes) are disregarded.

Example 1.—The stock of L corporation is publicly traded; no shareholder holds five percent or more. During the three-year period ending on January 1, 1989, there are numerous trades involving L stock. No owner shifts will occur so long as no person (or persons) becomes a five-percent shareholder and no more than 50 percent owner shift will occur unless any one or more such shareholders acquire more than 50 percent of the value of L stock.

Example 2.—On January 1, 1987, L corporation is publicly traded; no shareholder holds five percent or more. On September 1, 1987, individuals A, B and C, who were not previously shareholders of L and are unrelated to any such shareholders, each acquire one-third of the stock of L. Accordingly, A, B and C each become five-percent shareholders of L who, in the aggregate, have increased their holdings by over 50 percentage points from what they held at any point during the three years prior to September 1, 1987. Therefore, there has been a more than 50 percent owner shift.

Example 3.—On January 1, 1987, X owns all 1000 shares of corporation L. On June 15, 1987, he sells 300 of his L shares to A. On January 15, 1988, L issues 100 shares to each of B, C, and D. On December 15, 1988, L redeems more than 200 shares owned by X. Based on these facts, there is a more than 50-percent owner shift of L on December 15, 1988.

Example 4.—L corporation is closely held by four individuals. On January 1, 1987, there is a public offering of stock in L, as a result of which less-than-five-percent shareholders acquire stock representing 80 percent of the L stock that is outstanding. The 80 percentage point decrease in the holdings of five-percent shareholders results in a more than 50-percent owner shift.

Example 5.—On January 1, 1987, L is wholly owned by X. On January 1, 1988, X sells 50 percent of his stock to 1000 shareholders unrelated to him. On January 1, 1989, X sells his remaining 50-percent interest to an additional 1000 shareholders unrelated to him. Based on these facts, as of January 1, 1988, there has not been a more than 50 percent owner shift. On January 1, 1989, there is a more than 50 percent owner shift because as of that date a five-percent shareholder (X) decreased his holdings by more than 50 percentage points.

Equity structure change

An equity structure change is defined to include any tax-free reorganization other than a divisive reorganization. A more than 50

percent equity structure change occurs if, immediately after an equity structure change, the percentage of stock (by value) held by one or more of a loss corporation's shareholders is more than 50 percentage points more or less than the percentage of stock held by such shareholders at any time during the testing period. The determination of whether a more than 50-percent equity structure change has occurred is made by aggregating the increases or decreases in ownership for each shareholder. As described more fully below, owner shifts and prior equity structure changes are taken into account in determining whether a more than 50-percent equity structure change has occurred following an equity structure change. Prior transactions among less than five percent shareholders (which would not be owner shifts) are disregarded.

Example 6.—On January 1, 1988, L corportion is merged (in a tax-free transaction) into P corporation, with P surviving. Both L and P are publicly traded corporations with no shareholder owning as much as five percent of either corporation or of the surviving entity. In the merger, the former shareholders of L receive 30 percent of the stock of P, and the remaining stock of P is owned by P shareholders unrelated to the former shareholders of L. There has been a more than 50-percent equity structure change of L because the percentage of stock held by former L shareholders in the surviving corporation is more than 50 percentage points less than their prior holdings. If, however, the former shareholders of L received 70 percent of the stock of P in the merger, there would not be a more than 50-percent equity structure change of L.

Multiple transactions

The definition of the terms more than 50-percent owner shift and more than 50-percent equity structure change are both applied by comparing shareholders' ownership immediately after an owner shift or equity structure change with the shareholders' ownership at any time during the three-year testing period preceding the owner shift or equity structure change. Thus, changes in ownership that occur by reason of a series of transactions including both owner shifts and equity structure changes may constitute either a more than 50-percent equity structure change or more than 50-percent owner shift.

Example 7.—On January 1, 1989, I (an individual) purchases 40 percent of the stock of L. On July 1, 1989, L is merged into P—which is wholly owned by I—in a tax-free reorganization. In exchange for their stock in L, the L shareholders (immediately before the merger) receive stock with a value representing 60 percent of the P stock that is outstanding immediately after the merger. No other transactions occurred with respect to stock in L during the three-year period preceding the reorganization. The merger is treated as an equity structure change of more than 50 percent because, immediately after the merger, the percentage of stock held by L's shareholders other than I (36 percent) is more than 50 percentage points less than their holdings at a prior time during the testing period (100 percent).

Example 8.—On January 1, 1989, L corporation is owned by P, a corporation that owns 45 percent of the stock of L, and A and B, individuals who own 40 percent and 15 percent, respectively, of L

stock. Each of the L shareholders has owned their stock since L's inception in 1984. Neither A nor B owns any P stock. On July 30, 1989, B sells his entire 15-percent interest to C for cash. On August 13, 1989, P acquires A's entire 40-percent interest in exchange for P stock representing an insignificant percentage of the outstanding P voting stock in a B reorganization.

The B reorganization is treated as a more than 50-percent equity structure change because, immediately after the reorganization, the percentage of stock held by P and C (100 percent) is more than 50 percentage points more than the percentage of stock held by them at any time during the testing period (45 percent).

Example 9.—The stock of L corporation is widely held by the public; no single shareholder owns five percent or more of the L stock. G corporation also is widely held with no shareholder owning five percent or more. On January 1, 1988, L corporation and G corporation merge (in a tax-free transaction), with G shareholders receiving 49 percent of L corporation stock. On July 1, 1988, B, an individual who has never owned stock in either L or G, purchases five percent of L stock from shareholders who held L stock before the merger.

The merger of L and G is not treated as a more than 50 percent equity structure change because, immediately after the change, the percentage of stock held by L shareholders (51 percent) is not more than 50 percentage points less than the L stock held by them at any time during the testing period (100 percent). The purchase of L stock by B (which is an owner shift since B is a more than five percent shareholder after the change) is a more than 50-percent owner shift because, immediately after the owner shift, the percentage of the stock of L held by G shareholders and B (54 percent) is more than 50 percentage points more than the percentage of stock owned by those sharehodlers at any time during the testing period (0 percent).

Example 10.—The stock of L corporation and G corporation is widely held by the public; neither corporation has any five-percent shareholders. On January 1, 1988, B purchases 10 percent of L stock from several less than 5 percent shareholders. On July 1, 1988, L and G merge (in a tax-free transaction), with G shareholders receiving 49 percent of L stock.

The merger of L and G is a more than 50-percent equity structure change because, immediately after the merger, the percentage of stock of L (the new loss corporation) held by shareholders of L (the old loss corporation) (49 percent) is more than 50 percentage points less than the percentage of stock of the old loss corporation held by those shareholders at any time during the testing period (100 percent). In determining whether the merger is a more than 50-percent equity structure change, the other transactions that must be considered are other equity structure changes or owner shifts (*i.e.*, transactions involving five percent shareholders, such as B's stock purchase on January 1, 1988) that have occurred during the testing period.

Attribution of stock ownership

In determining ownership of stock for purposes of determining whether an ownership change has occurred, the constructive own-

ership rules of section 318 are applied, except (1) the rules for attributing ownership among corporations and their shareholders are applied by substituting five percent for 50 percent, (2) a corporation is considered as owning stock (other than stock in such corporation) owned by or for any shareholder of the corporation, in the proporion that the value of the stock owned by such shareholder in the corporation bears to the value of all stock in the corporation, and (3) except to the extent provided in regulations, the rules relating to the ownership of stock subject to an option will not apply. The bill also provides that the special limitations will not apply to the acquisition of one corporation by another corporation under common control.

The receipt or acquisition of certain stock is not taken into account in determining whether an ownership change has occurred. This rule applies if (1) the basis of the stock in the hands of a person is determined under section 1014 (relating to property acquired from a decedent) or section 1015 (relating to property acquired by gift), (2) the stock is received in satisfaction of a pecuniary bequest, (3) stock is acquired pursuant to a divorce or separation instrument (within the meaning of section 71(b)(2)), or (4) the stock is received in a transaction that constitutes an acquisition of employer securities (within the meaning of section 409(l)) by a tax credit employee stock ownership plan or an employee stock ownership plan (within the meaning of section 4975(e)(7)), or by a participant of such a plan pursuant to the requirements of section 409(h).

Three-year testing period

In general, the relevant testing period is the three-year period ending on the day of an owner shift or an equity structure change. Thus, a series of unrelated transactions occurring during a three-year period may constitute either a more than 50-percent owner shift or a more than 50-percent equity structure change. A shorter period is applicable where there has been a prior ownership change. In such a case, the testing period for determining whether a subsequent ownership change has occurred does not begin before the first day following the testing period for the earlier ownership change.

Under a special rule, the testing period will not begin before the first taxable year from which there is a carryforward of a loss or an excess credit to the first post-change year. This rule does not apply to a corporation that has a net unrealized built-in loss (as determined below) immediately before the change date.

Effect of ownership change

Section 382 limitation

For any taxable year ending after the change date (*i.e.*, the date of a more than 50-percent owner shift or a more than 50-percent equity structure change), the amount of a loss corporation's taxable income that can be offset by a pre-change loss cannot exceed the section 382 limitation for such year. For purposes of this rule, a corporation's taxable income is computed with the modifications set forth in section 172(d). The section 382 limitation for any taxable year is an amount equal to the value of the loss corporation

immediately before the ownership change, multiplied by the Federal mid-term rate in effect on the change date. If the section 382 limitation for a taxable year exceeds the taxable income for the year, the section 382 limitation for the next taxable year is increased by the amount of the excess. The section 382 limitation for a taxable year is also increased by certain "built-in gains" (discussed below). A special rule is included to ensure that a target corporation (as defined in section 338(d)) will be able to use pre-change NOL carryforwards to offset gain recognized on a deemed sale of assets under section 338(a).

Special rule for post-change year that includes the change date.—For the taxable year in which a change occurs, the section 382 limitation does not apply to the portion of a loss corporation's taxable income (computed without regard to recognized built-in gains or losses, described below) that is allocable (determined, except as provided in regulations, on a daily pro rata basis) to the period in such year before the change date. For the taxable year in which a change occurs, the section 382 limitation is equal to an amount that bears the same ratio to the section 382 limitation (determined without regard to this rule) as the number of days in such year on or after the change date bears to the total number of days in such year. If there are less than 365 days in any post-change year, the section 382 limitation for the taxable year is equal to an amount that bears the same ratio to such limitation (determined without regard to this rule for short taxable years) as the number of days in the post-change year bears to 365.

Built-in gains

If a loss corporation has a net unrealized built-in gain, the section 382 limitation for any taxable year ending within the five-year recognition period is increased by the recognized built-in gain for the taxable year.

Net unrealized built-in gains.—The term "net unrealized built-in gain" is defined as the amount by which the value of a corporation's assets exceeds the aggregate bases of such assets immediately before the ownership change. Under a de minimis exception, the special rule for built-in gains is not applied if the amount of a net unrealized built-in gain does not exceed 25 percent of the value of a corporation's assets. For purposes of the de minimis exception, the aggregate bases of a corporation's assets is determined by excluding any (1) cash, (2) cash items, or (3) marketable securities (as defined for purposes of the de minimis exception applicable to built-in losses).

Recognized built-in gains.—The term "recognized built-in gain" is defined as any gain recognized on the disposition of an asset during the recognition period, if the taxpayer establishes that (1) the asset was held by the loss corporation immediately before the change date, and (2) the gain is allocable to a period before the change date. The recognized built-in gain for a taxable year cannot exceed the net unrealized built-in gain reduced by the recognized built-in gains for prior years in the recognition period.

Value of loss corporation

Generally, the value of a loss corporation is the fair market value of the corporation's stock (including stock that would be excluded under section 1504(a)) immediately before the ownership change. The price at which stock in the loss corporation changes hands would be evidence, but not conclusive evidence, of the value of the corporation's stock. For example, assume that an acquiring corporation purchased 40 percent of stock in a loss corporation over a 12-month period. Six months after the end of the initial acquisition period, the acquiring corporation purchases an additional 20-percent of the loss corporation's stock at a price that reflects a premium over the stock's fair market value; the premium is paid because the 20-percent block carries with it effective control of the loss corporation. On these facts, it would be inappropriate simply to gross-up the amount paid for the 20-percent interest to determine the corporation's equity value.

Federal mid-term rate

The Federal mid-term rate is the rate that is (1) determined by the Secretary under section 1274 (relating to debt instruments issued for property), based on the average yield for mid-term marketable obligations of the U.S. Government, and (2) in effect on the change date.

Example 11.—Corporation L has $1 million of net operating loss carryforwards. L's taxable year is the calendar year, and on July 1, 1987, all of the stock of L is sold in a transaction constituting an ownership change of L. (Assume the transaction does not terminate L's taxable year.) On that date, the value of L's stock was $500,000 and the Federal mid-term rate was 10 percent. Finally, L incurred a net operating loss during 1987 of $100,000, and L had no built-in gains or losses.

On these facts, the taxable income of L after July 1, 1987, that could be offset by L's losses incurred prior to July 1, 1987, would generally be limited. In particular, for all taxable years after 1987, the pre-change losses of L generally could be used to offset no more than $50,000 of L's taxable income each year. (For L's 1987 taxable year, the limit would be $25,000 (1/2 x $50,000 section 382 limitation)). The "pre-change losses" of L would constitute the $1 million of NOL carryforwards plus one-half of the 1987 net operating loss, or a total of $1,050,00. If, in taxable year 1988, L had $30,000 of taxable income to be offset by L's losses, it could be fully offset by L's pre-change NOLs and the amount of L's 1989 taxable income that could be offset by pre-change losses would be limited to $95,000 ($50,000 annual limit plus $45,000 carryover).

If L had income of $100,000 in 1987, instead of a net operating loss, L's 1987 taxable income that could be offset by pre-trigger losses would generally be limited to $75,000 (1/2 x $50,000 section 382 limitation plus 1/2 x $100,000 1987 income). (In appropriate circumstances, the Secretary could by regulations require allocation of income using a method other than daily proration. Such circumstances might include, for example, an instance in which substantial income-producing assets are contributed to capital after the change date.)

Reduction in loss corporation's value for certain capital contributions

Any capital contribution that is received by a loss corporation as part of a plan the principal purpose of which is to avoid any of the special limitations under section 382 is not taken into account. For purposes of this rule, except as provided by regulations, a capital contribution made during the two-year period ending on the change date is presumed to be part of a plan to avoid the special limitations. The application of this rule will result in a reduction of the loss corporation's value for purposes of determining the section 382 limitation for post-change years. The committee contemplates that regulations could except capital contributions received on formation of a loss corporation (where an ownership change occurs within two years of incorporation) and capital contributions made to continue basic operations of the corporation's business (*e.g.*, to meet the monthly payroll needs of the corporation). The regulations also may take into account, under appropriate circumstances, distributions made to shareholders subsequent to capital contributions, as an offset to such contributions.

Treatment of investment companies

If a loss corporation is an investment company immediately before an ownership change, then the section 382 limitation for all post-change years is treated as zero for any post-change year (*i.e.*, NOL and credit carryforwards are eliminated). The term "investment company" is generally defined as any corporation if at least two-thirds of the value of the corporation's assets consists of assets held for investment. Regulated investment companies and real estate investment trusts are excluded from the definition of investment companies.

Assets held as an integral part of the conduct of a trade or business (*e.g.* assets funding reserves of an insurance company) would not be considered investment assets. In addition, stock or securities in a subsidiary corporation are not treated as investment assets. Instead, the parent corporation is deemed to own its ratable share of the subsidiary's assets. A corporation is treated as holding stock in a subsidiary if the corporation owns 50 percent or more of the combined voting power of all classes of stock entitled to vote, or 50 percent or more of the total value of all classes of stock.

Losses subject to limitation

The term "pre-change loss" includes (1) for the taxable year in which a change occurs, the portion of the loss corporation's NOL that is allocable (determined, except as provided in regulations, on a daily pro rata basis) to the period in such year before the change date, (2) NOL carryforwards that arose in a taxable year preceding the taxable year of the change, and (3) certain recognized built-in losses and deductions (described below).

For any taxable year in which a corporation has income that, under section 172, may be offset by both a pre-change loss (*i.e.*, an NOL subject to limitation) and an NOL that is not subject to limitation, taxable income is treated as having been first offset by the

pre-change loss. This rule minimizes the NOLs that are subject to the special limitations.

Built-in losses

If a loss corporation has a net unrealized built-in loss, the recognized built-in loss for any taxable year ending within the five-year period ending at the close of the fifth post-change year (the "recognition period") is treated as a pre-change loss.

Net unrealized built-in losses.—The term "net unrealized built-in loss" is defined as the amount by which the aggregate adjusted bases of a corporation's assets exceeds the value of the corporation's assets immediately before the ownership change. Under a de minimis exception, the special rule for built-in losses is not applied if the amount of a net unrealized built-in loss does not exceed 25 percent of the value of a corporation's assets immediately before the ownership change. For purposes of the de minimis exception, the value of a corporation's assets is determined by excluding any (1) cash, (2) cash items (as determined under for purposes of section 368(a)(2)(F)(iv)), or (3) marketable securities that have not declined or appreciated substantially in value (as defined in regulations).

Example 12.—L, a corporation, holds two assets: asset X, with a basis of 150 and a value of 50 (a built-in loss asset), and asset Y, with a basis of zero and a value of 50 (a built-in gain asset). L has a net unrealized built-in loss of 50 (the excess of the aggregate bases of 150 over the aggregate value of 100).

Recognized built-in losses.—The term "recognized built-in loss" is defined as any loss that is recognized on the disposition of an asset during the recognition period, except to the extent the taxpayer establishes that (1) the asset was not held by the loss corporation immediately before the change date, or (2) the loss (or a portion of such loss) is allocable to a period after the change date. The recognized built-in loss for a taxable year cannot exceed the net unrealized built-in loss reduced by recognized built-in losses for prior taxable years ending in the recognition period.

Accrued deductions.—The Secretary is authorized to issue regulations under which amounts that accrue before the change date but are allowable as a deduction on or after such date (*e.g.*, deductions deferred by section 267 or section 465) will be treated as built-in losses. Under the committee bill, depreciation deductions could not be treated as accrued deductions or built-in losses.

Bankruptcy proceedings

The special limitations do not apply after any ownership change of a loss corporation if (1) such corporation was under the jurisdiction of a bankruptcy court immediately before the ownership change, and (2) the corporation's shareholders and creditors (determined immediately before the ownership change) own 50 percent of the loss corporation's stock immediately after the ownership change. For purposes of this rule, stock of a creditor that was converted from indebtedness is taken into account only if such indebtedness was held by the creditor for at least one year before the date the bankruptcy case was filed or arose in the ordinary course of the loss corporation's trade or business.

If the exception for bankruptcy proceedings applies, the loss corporation's pre-change NOL carryforwards are reduced by the interest on indebtedness that was converted to stock in the proceeding and paid or accrued during the period beginning on the first day of the third taxable year preceding the taxable year in which the ownership change occurs and ending on the change date.

After an ownership change that qualifies for the bankruptcy exception, a second ownership change during the following two-year period will result in the elimination of NOL carryforwards that arose before the first ownership change. This limitation reflects the view that any value created during the two-year period is likely attributable to capital contributions, including the cancellation of indebtedness that occurred in the bankruptcy proceeding (and contributions during the two-year period preceding a change are presumptively removed from a loss corporation's value).

Thrift institutions

A modified version of the bankruptcy exception (described above) applies to certain ownership changes of a thrift involved in a G reorganization by virtue of section 368(a)(3)(D)(ii). This rule also applies to ownership changes resulting from an issuance of stock or equity structure change that is an integral part of a transaction involving such a reorganization, provided that the transaction would not have resulted in limitations under present law.[11a] The bankruptcy exception is applied to qualified thrift reorganizations by requiring shareholders and creditors (including depositors) to retain a 20-percent (rather than 50-percent) interest. For this purpose, the deposits of the troubled thrift that become deposits in the acquiring corporation are treated as stock, as under present law. The general bankruptcy rule that eliminates from the NOL carryforwards interest deductions on debt that was converted is not applicable to interest paid on deposits by thrifts qualifying under this provision.

Transactions involving solvent thrifts, including a purchase of the stock of a thrift, or merger of a thrift into another corporation, will be subject to the general rules relating to ownership changes. The conversion of a solvent mutual savings and loan association into a stock savings and loan (or other transactions involving a savings and loan not entitled to special treatments) although not within the special rules applicable to troubled thrifts, will not necessarily constitute an ownership change under the bill. In such a conversion, the mutual thrift converts to stock form as a preliminary step to the issuance of stock to investors for purposes of raising capital. Under the bill, the entire transaction will qualify as a tax-free reorganization to the same extent as under present law. For purposes of determining whether there has been an ownership change causing a limitation on the use of losses under the bill, the issuance of stock will be treated under the general rules applicable to owner shifts. For example, if the stock were issued entirely to

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[11a] For example, a supervisory conversion of a mutual thrift into a stock thrift qualifying under section 368(a)(3)(D)(ii), followed by an issuance of stock for cash, would come within this special rule. The issuance of stock would not be regarded as a second ownership change for purposes of the bankruptcy exception.

non-five-percent shareholders, or five-percent shareholders acquired 50 percent or less of the stock, no owner shift would occur.

Carryforwards other than NOLs

The bill also amends section 383, relating to special limitations on unused business credits and research credits, excess foreign tax credits, and capital losses. Under regulations to be prescribed by the Secretary, capital loss carryforwards and the deduction equivalent of credit carryforwards will be limited to an amount determined on the basis of the tax liability that is attributable to so much of the taxable income as does not exceed the section 382 limitation for the taxable year, with the same ordering rules that apply under present law. The bill expands the scope of section 383 to include passive activity losses and credits and minimum tax credits.

Anti-abuse rules

The bill does not alter the continuing application of section 269, relating to acquisitions made to evade or avoid taxes. Similarly, the SRLY and CRCO rules under the regulations governing the filing of consolidated returns will continue to apply.

The bill provides that the Treasury Department shall prescribe such regulations as may be necessary or appropriate to prevent the avoidance of the special limitations through the use of related persons, pass-through entities, or other intermediaries.

Libson Shops

The committee intends that the *Libson Shops* doctrine will have no application to transactions subject to the provisions of the bill.

1976 Act Amendments

The bill generally repeals the amendments made by the Tax Reform Act of 1976, effective retroactively as of January 1, 1986. Thus, the law that was in effect as of December 31, 1985, applies to ownership changes that are not subject to the bill's provisions because of the bill's effective date.

Effective Dates

The provisions of the bill apply to more than 50-percent owner shifts that occur on or after January 1, 1987. In the case of equity structure changes, the new rules apply to reorganizations pursuant to plans adopted on or after January 1, 1987. For purposes of these rules, if there is an ownership change with respect to a subsidiary corporation as the result of the acquisition of the parent corporation, the subsidiary's treatment is governed by the nature of the parent corporation, the subsidiary's treatment is governed by the nature of the parent-level transaction. For example, if a parent corporation is acquired in a tax-free reorganization pursuant to a plan adopted before January 1, 1987, then the resulting indirect ownership change with respect to to a subsidiary loss corporation will be treated as having occurred by reason of a reorganization pursuant to a plan adopted before January 1, 1987.

A reorganization plan will be considered adopted on the date that the boards of directors of all parties to the reorganization

adopt the plans or recommend adoption to the shareholders, or on the date the shareholders approve, whichever is earlier. The parties' boards of directors may approve a plan of reorganization based on principles, and negotiations to date, and delegate to corporate officials the power to refine and execute a binding reorganization agreement, including a binding agreement subject to regulatory approval. Any subsequent board approval or ratification taken at the time of consummating the transaction as a formality (*i.e.*, that is not required, because the reorganization agreement is already legally binding under prior board approval) may occur without affecting the application of the effective date rule for reorganizations. In the case of a reorganization that occurs as part of Title 11 or other court-supervised proceeding, a plan of reorganization will be considered adopted on the date that the court confirms the plan.

The earliest testing period under the bill begins on May 6, 1986 (the date of committee action). If a more than 50-percent owner shift or equity structure occurs after May 5, 1986, but before January 1, 1987, and sections 382 and 383 (as amended by the bill) do not apply, then the earliest testing date will not begin before the date of such ownership change. For example, assume 60 percent of a loss corporation's stock (wholly owned by X) is purchased by B on May 29, 1986, and the special limitations do not apply (because, *e.g.*, the loss corporation's business is continued and section 269 is not implicated). Assume further that X's remaining 40 percent stock interest is acquired by B on February 1, 1987. Under the bill, no ownership change occurs after the second purchase because the testing period would not begin before May 29, 1986; thus, a more than 50-percent owner shift would not result from the second purchase. Conversely, if 40 percent of a loss corporation's stock (wholly owned by X) is purchased by D on July 1, 1986, and an additional 15 percent is purchased by P on January 15, 1987, then a more than 50-percent owner shift would result from the second purchase, and the bill would apply to limit the use of the loss corporation's NOLs.

Special transitional rules are provided under which present law continues to apply to certain ownership changes after January 1, 1987.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $18 million in 1987, $45 million in 1988, $49 million in 1989, $49 million in 1990, and $49 million in 1991.

6. Extraordinary Dividends Received by Corporate Shareholders (sec. 614 of the bill and sec. 1059 of the Code)

Present Law

Under present law, a corporate shareholder is generally permitted to deduct 85 percent (100 percent in the case of stock in 80-percent-or-more-owned subsidiaries) of the amount of dividends received from domestic corporations (secs. 243-246). Intercorporate dividends are therefore taxed at a maximum rate of 6.9 percent (15 percent, the includible portion of the dividend, multiplied by the

maximum corporate rate of 46 percent). However, if a dividend constitutes an "extraordinary" dividend and the shareholder sells or otherwise disposes of the stock before it has been held for more than one year, the shareholder's adjusted basis in the stock is reduced by the nontaxed portion of the dividend (sec. 1059). If the nontaxed portion of an extraordinary dividend exceeds the shareholder's adjusted basis in the stock with respect to which it was paid, the excess is treated as gain from the sale or exchange of property.

An extraordinary dividend is defined by reference to the adjusted basis of the share of stock with respect to which it is distributed. A dividend is extraordinary if it exceeds 10 percent (5 percent in the case of a share of stock preferred as to dividends) of the shareholder's basis in the share, determined without regard to this provision.

In the case of a cash distribution, the nontaxed portion of the dividend is the amount that is offset by the dividends received deduction. In the case of a distribution of property, the nontaxed portion is the fair market value of the property (reduced, as provided in sec. 301(b)(2), for liabilities assumed by the shareholder or to which the shareholder is subject), less any portion of such amount that is not offset by the dividends received deduction.

Reasons for Change

The committee believes that the extraordinary dividend provision in its present form has proved to be an inadequate deterrent to the tax-motivated transactions at which the provision, enacted in 1984, was directed. Taxpayers have been able to obtain the tax benefits that Congress intended to curtail in the 1984 Act, simply by holding stock beyond the one-year period.

For example, a corporation may still acquire stock in another corporation following or in anticipation of the latter's announcement that it will pay a large dividend, and may hold the stock with the intention of disposing of it shortly after the expiration of the one-year holding period necessary to avoid a basis reduction under section 1059. As in cases where the stock is held for less than one year, after the distribution the shareholder will have dividend income taxable at a maximum rate of 6.9 percent, and the market price of the dividend-paying stock will have declined by approximately the value of the dividend. But the shareholder's basis in the shares will reflect its full cost, since no reduction in the basis is required to reflect the tax-free portion of the intercorporate dividend. Thus, the stock may then be disposed for an amount that creates a loss for tax purposes, which could offset capital gains otherwise taxable at a maximum rate of 28 percent realized by the shareholder on other transactions.[12] The taxpayer has thus obtained a 21.1 percent tax "arbitrage" benefit at essentially no actual economic cost. The bill's reduction of the maximum rate on

[12] Although the shareholder in such transactions is exposed to the risk that the value of the stock will decline during the one-year holding period, taxpayers have continued to engage in such transactions. Given the substantial potential tax benefit, the apparent premise for the more-than-one-year holding period requirement of present law—that the shareholder's exposure to market risk during this period would be sufficient to deter such tax arbitrage—in many situations may be unfounded.

intercorporate dividends to 6.6 percent will increase the potential arbitrage benefit for a corporation that has capital gains.

The committee is also concerned that present law may allow corporate shareholders to realize unintended tax benefits on dispositions of stock that was not necessarily acquired for tax avoidance purposes, but with respect to which substantial nontaxable amounts have been received. The committee believes that if a corporate shareholder receives an extraordinary dividend with respect to stock, the nontaxed portion of the dividend should reduce the shareholder's basis in the stock, without regard to the holding period. However, the committee believes that it is appropriate to mitigate the application of this provision to extraordinary dividends as defined under present law where the shareholder can demonstrate that the stock has significantly appreciated since the shareholder's original investment. Accordingly, the bill provides an alternative test for whether a dividend is extraordinary based on the fair market value of the stock, but only in situations in which the taxpayer is able to establish the fair market value of the stock to the satisfaction of the Commissioner.

Explanation of Provision

Under the bill, a corporation that disposes of a share of stock must reduce its basis therein (but not below zero) by the nontaxed portion of any extraordinary dividend paid with respect to the share at any time during the corporation's holding period for the stock. This basis reduction is required only for purposes of determining gain or loss on the disposition of the share. If the aggregate nontaxed portions of extraordinary dividends exceed the shareholder's basis, the excess will be treated as gain from a sale or exchange at the time of disposition.

The bill provides a taxpayer the option of determining the status of a distribution as an extraordinary dividend by reference to the fair market value of the share on the day before the ex-dividend date in lieu of its adjusted basis. This special rule applies only if the taxpayer establishes the fair market value of the share to the satisfaction of the Commissioner.

As under present law, if the corporate shareholder and the payor of the dividend are members of an affiliated group filing consolidated returns, the shareholder will not be required to reduce its basis in the stock under both this provision and under Treas. Reg. section 1.1502-32(b)(2)(iii). Thus, no portion of a distribution may reduce basis twice.

Effective Date

The provision applies to dividends declared after March 18, 1986.

Revenue Effect

This provision will increase fiscal year budget receipts by $30 million in 1987, $50 million in 1988, $53 million in 1989, $55 million in 1990, and $58 million in 1991.

7. Allocation of Purchase Price in Certain Sales of Assets (sec. 632 of the bill and new section 1060 of the Code)

Present Law

A sale of a going business for a lump-sum amount is viewed as a sale of each individual asset rather than of a single capital asset.[13] Both the buyer and the seller must allocate the purchase price among the assets for tax purposes. An allocation by the seller is necessary to determine the amount and character of the gain or loss, if any, it will recognize on the sale. An allocation by the buyer is necessary to determine its basis in the assets purchased. This allocation of basis will affect the amount of allowable depreciation or amortization deductions and the amount and character of any gain or loss recognized by the buyer on a subsequent sale, and may have other tax consequences.

Although the parties may agree to a specific allocation of the purchase price among the assets and reflect this allocation in the sales contract, the Code does not require such agreement; thus, the contract may simply state the total purchase price. If the parties do make a specific contractual allocation with appropriate regard to value they are generally bound by this allocation for tax purposes.[14] Similarly, the courts and the Internal Revenue Service generally accept a stated allocation with appropriate regard to value provided the parties have adverse tax interests with respect to the allocation.

In general, a seller will benefit if a larger portion of the purchase price is allocable to "pure" capital assets, such as goodwill or going concern value, or (to a lesser extent) to section 1231 assets. If the sale is taxable to the seller, allocations to capital assets will result in tax at the lower capital gains rates, while allocations to ordinary income assets such as inventory will result in tax at ordinary income rates. Amounts allocated to section 1231 assets may result in tax at the preferential capital gains rate, but could produce depreciation recapture income under section 1245 or 1250 or income recognition under other provisions of the Code.

Even if the seller is a liquidating corporation and the sale is governed by section 337, so that no gain or loss is recognized except for recapture and certain other items, the allocation of purchase price may have tax consequences for the seller. The allocation will determine the amount of recapture income recognized and may affect the extent to which other income is recognized.[15]

A buyer, on the other hand, will benefit from an allocation that results in a higher basis for inventory or other assets that would generate ordinary income if resold; to depreciable tangible assets such as buildings and equipment; or to intangible assets having determinable useful lives, which would be amortizable.

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[13] *Williams* v. *McGowan*, 152 F.2d 570 (2d Cir. 1945).

[14] See, e.g., *Ullman* v. *Comm'r*, 264 F. 2d 305 (2d Cir. 1959); *Comm'r* v. *Danielson*, 378 F. 2d 771 (3d Cir. 1967) *cert. den.* 389 U.S. 858.

[15] For example, the allocation could affect the amount of income recognized under the tax benefit doctrine or other judicial exceptions to section 337. It could also affect the amount of LIFO recapture with respect to inventory and the amount of additional inventory gain if the bulk sale exception of section 337 did not apply.

The interests of the buyer and seller are not necessarily adverse in the case of section 1231 assets, since the allocation may result in capital gain (or nonrecognition of gain under sec. 337) to the seller while according depreciable basis to the buyer. In some circumstances, however, the allocation will produce recapture income to the seller. In the case of certain intangibles, the parties' interests also may not be adverse because the seller will recognize capital gain (or no gain under sec. 337) with respect to the intangible, while the buyer may acquire an amortizable asset.

If the parties to the sale of a going business fail to make an allocation of the purchase price among the assets of the business that is respected for tax purposes, the purchase price (less cash and cash equivalents) must still be allocated among the non-cash assets in proportion to their respective fair market values on the date of the sale.[16] Fair market value has been defined under one formulation as the price arrived at by a willing buyer and a willing seller, neither being under a compulsion to buy or sell. No single method of valuation is regarded as determinative of value in all circumstances. Three commonly accepted methods are the reproduction cost method, the capitalization of earnings method, and the comparable sales method.

The valuation of goodwill and going concern value is generally recognized as more difficult than the valuation of tangible assets or certain other types of intangibles. The two most commonly used methods to value goodwill and going concern value are the residual method and the formula method.[17] Under the residual method, the value of the goodwill and going concern value is the excess of the purchase price of the business over the aggregate fair market values of the tangible assets and the identifiable intangible assets other than goodwill and going concern value. Under the formula method, goodwill and going concern value are valued by capitalizing the excess earning capacity of the tangible assets of the business based upon the performance of the business over some period prior to the valuation date. The excess earning capacity is the excess of the average earnings of the business during this period over an assumed rate of return on the value of its tangible assets.[18] These excess earnings, capitalized at an appropriate discount rate,[19] are deemed to be the value of the unidentified intangibles.

While the Service has recognized a formula method as a permissible method of valuing goodwill and going concern value, it has also stated the position that the method is appropriate only where there is no better evidence of the value of these intangibles.[20] The courts appear reluctant to apply the formula method because of the subjectivity involved in selecting the appropriate rate of return and capitalization rate. In cases where the value of tangible and identifiable intangible assets can be ascertained with reasonable

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[16] See Treas. Reg. sec. 1.167(a)-5.

[17] As described in A.R.M. 34, 2 C.B. 31 (1920), *superseded by* Rev. Rul. 68-609, 1968-2 C.B. 327.

[18] This assumed rate of return is the rate prevailing on the valuation date in the industry in which the business is classified, adjusted to reflect the risk involved in the particular business.

[19] Here too the rate must reflect the riskiness of the particular business.

[20] Rev. Rul. 68-609, supra.

certainty, the courts have generally rejected the formula approach in favor of the residual method.[21]

In some cases a taxpayer who has purchased a going business at a premium (that is, the price that it has determined exceeds the apparent aggregate fair market values of the tangible and intangible assets, including goodwill and going concern value) might take the position that it is entitled to allocate an amount in excess of fair market value to the basis of individual assets. Relying on one interpretation of the judicial and administrative authorities,[22] the taxpayer would separately value each of the acquired assets and allocate the premium among all the assets (other than cash and cash equivalents) in proportion to their relative fair market values in a so-called "second-tier allocation."

Proposed and temporary regulations recently issued by the Treasury Department under section 338 mandate a residual method of allocation (and prohibit a second-tier allocation) in determining the basis of assets acquired in a qualified stock purchase for which a section 338 election is made or is deemed to have been made, i.e., a stock purchase which is treated as a purchase of assets for tax purposes.[23] The deemed purchase price of the assets is first reduced by cash and items similar to cash, and is then allocated sequentially to two defined classes of identifiable tangible and intangible assets; any excess is allocated to assets in the nature of goodwill and going concern value. After the reduction for cash items, no amount may be allocated to any asset in the next two classes in excess of its fair market value.[24]

Reasons for Change

The committee is aware that the allocation of purchase price among the assets of a going business has been a troublesome area of the tax law. Purchase price allocations have been an endless source of controversy between the Internal Revenue Service and

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[21] *E.g., Banc One Corp.* v. *Comm'r*, 84 T.C. 476 (1985); *Jack Daniel Distillery* v. *United States*, 379 F.2d 569 (Ct.Cl. 1967); *Black Industries, Inc.* v. *Comm'r*, 38 T.C.M. 242 (1979). *Compare Concord Control Inc.* v. *Commissioner*, 78 T.C. 742 (1982) (in which the court stated that it was rejecting the residual method of valuation because of the difficulty of ascertaining other fair market values, but nevertheless based its approach on a finding of such values). The residual method is also applied in computing the value of goodwill under generally accepted accounting principles. A.P.B. Opinion Nos. 16 and 17 (November 1, 1970).

[22] Some taxpayers refer to Rev. Rul. 77-456, 1977-2 C. B. 102, although that ruling did not involve a purchase for a price other than the value of all the assets. The ruling involved a purchase price that was stated to represent the fair market value of all the corporate assets at the time of purchase, and addressed only the issue of allocating basis under section 334(b)(2) when there were post-acquisition changes in asset value occurring prior to the liquidation of the acquired target. *See also United States* v. *Cornish*, 348 F.2d 175 (9th Cir. 1965), a case involving the valuation of partnership assets in the context of a sale of partnership interests. The court there found that a "premium" had been paid, but was able to identify the items to which it was attributable—one, the value of certain partners' future services, and the other, the value of an interest element in a deferred purchase price that the law at the time did not require be accounted for as interest. It nevertheless allowed amounts attributable to these items to be allocated to other assets apparently because it concluded that the partners' services were not an "asset" that was purchased, and that it had no mechanism to treat the interest element as interest.

[23] Prop. and Temp. Treas. Reg. sec. 1.338(b)-2T.

[24] The proposed and temporary regulations apply to all stock acquisitions occurring after August 31, 1982. However, the Internal Revenue Service has announced that it will amend the regulations to provide an election for acquisitions occurring before January 30, 1986. A taxpayer making this "transitional allocation election" may allocate basis according to the current law rules applicable when a group of assets are acquired for a lump-sum purchase price. The electing taxpayer will be required to inform the Service of the method of allocation used. See IR-86-43 (April 8, 1986).

taxpayers, principally because of the difficulty of establishing the value of goodwill and going concern value. The Service lacks the resources to challenge allocations to goodwill or going concern value in all or even a substantial portion of the cases in which it would otherwise assert that the value of those assets are misstated.

The committee believes that it is appropriate to treat the "premium" involved in second-tier allocations as a payment for assets in the nature of goodwill or going concern value, rather than a payment in excess of the total value of the purchased assets. The committee therefore is requiring taxpayers to apply the residual method in allocating basis to goodwill and going concern value in all purchases of a going business. The mandatory application of the residual method is also warranted in view of the difficult and uncertain assumptions that are demanded by the application of the formula method and the excessive amount of conflict generated between taxpayers and the Service concerning its application.

The method adopted by the bill is identical to that provided in the regulations under section 338 for allocating purchase price to assets following a stock purchase. Thus, the committee's solution will not only tend to reduce controversies between the Service and taxpayers, it will also eliminate disparities between asset purchases and stock purchases treated as asset purchases under section 338 insofar as purchase price allocations are concerned.

In adopting the basis allocation rules as prescribed by the section 338 regulations, the committee intends no inference as to the propriety under present law of methods of allocation in asset acquisitions other than the residual method.

The committee is also concerned about the potential for abuse inherent in the sale of a going business where there is no agreement between the parties as to the value of specific assets. In many instances the parties' allocations for tax reporting purposes are inconsistent, resulting in a whipsaw of the government. The committee expects that requiring both parties to use the residual method for allocating amounts to nonamortizable goodwill and going concern value may diminish some of this "whipsaw" potential. The committee has also authorized the Treasury Department to require reporting by parties to the sale of a business, so that information reporting may be required regarding amounts allocated to goodwill and going concern value and to any other categories of assets or specific assets, and such other information as the Secretary deems necessary or appropriate.

Explanation of Provision

The bill requires that, in the case of any "applicable asset acquisition," both the buyer and the seller must allocate purchase price in the manner prescribed in section 338(b)(5). Thus, both parties must use the residual method as described in the regulations under section 338. *See* Temp. Treas. Reg. sec. 1.338(b)-2T. An applicable asset acquisition is any transfer of assets constituting a business in which the transferee's basis is determined wholly by reference to the purchase price paid for the assets. Both direct and indirect transfers of a business are intended to be covered by this provision, including, for example, a sale of a business by an individual or a

partnership, or a sale of a partnership interest in which the basis of the purchasing partner's proportionate share of the partnership's assets is adjusted to reflect the purchase price. A group of assets will constitute a business for this purpose if their character is such that goodwill or going concern value could under any circumstances attach to such assets. For example, a group of assets that would constitute an active trade or business within the meaning of section 355 will in all events be considered a business for purposes of this provision. Moreover, businesses that are not active businesses under section 355 will also be subject to this rule.

In requiring use of the residual method, the committee does not intend to restrict in any way the ability of the Internal Revenue Service to challenge the taxpayer's determination of the fair market value of any asset by any appropriate method. For example, in certain cases it would be reasonable for the Service to make an independent showing of the value of goodwill or going concern value as a means of calling into question the validity of the taxpayer's valuation of other assets.

The bill also authorizes the Treasury Department to require information reporting by the parties to an applicable asset acquisition. This may include information regarding amounts allocated to goodwill or going concern value, as well as any other categories of assets or specific assets, and such other information as it deems necessary or appropriate.

Effective Date

The provision is effective for transactions after May 6, 1986, unless pursuant to a binding contract in effect on that date and at all times thereafter.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $58 million in 1987, $55 million in 1988, $65 million in 1989, $74 million in 1990, and $80 million in 1991.

B. Rapid Amortization Provisions

1. Five-year Amortization of Trademark and Trade Name Expenditures (sec. 634 of the bill and sec. 177 of the Code)

Present Law

Taxpayers may elect to amortize over a period of at least 60 months expenditures for the acquisition, protection, expansion, registration, or defense of a trademark or trade name, other than an expenditure which is part of the consideration for an existing trademark or trade name.

Reasons for Change

Congress enacted the special amortization provision for trademark and trade name expenditures in 1956 in part because of a perception that certain large companies whose in-house legal staff handled trademark and trade name matters were able in some cases to deduct compensation with respect to these matters, because of difficulties of identification, while smaller companies that retained outside counsel were required to capitalize such expenses.[25] The committee does not believe that the possibility that some taxpayers may fail accurately to compute nondeductible expenses is a justification for permitting rapid amortization. Furthermore, to the extent such mischaracterization occurs, a five-year amortization provision only partially alleviates any unfairness. There is no basis for a presumption that a trademark or trade name will decline in value, or that investment in trademarks and trade names produces special social benefits that market forces might inadequately reflect. The committee believes that a tax incentive for trademark or trade name expenditures is therefore inappropriate.

Explanation of Provision

The election is repealed. Trademark and trade name expenditures will, therefore, be capitalized and generally recovered on disposition of the asset.

Effective Date

The repeal is effective for expenditures paid or incurred after December 31, 1986. However, present law will continue to apply to expenditures incurred (1) pursuant to a written contact that was binding as of March 1, 1986; or (2) with respect to development, protection, expansion, registration or defense of trademarks or trade names commenced as of March 1, 1986, if the lesser of $1 million or

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[25] See, S. Rep. No. 1941, 84th Cong. 2d Sess., pp. 8-9 (1956).

5 percent of the cost has been incurred or committed by that date; provided in each case the trademark or trade name is placed in service before January 1, 1988.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $4 million in 1987, $13 million in 1988, $25 million in 1989, $41 million in 1990, and $57 million in 1991.

2. Deduction for Loss in Value of Certain Bus Operating Authorities (sec. 635 of the bill)

Present Law

Prior to enactment of the Bus Regulatory Reform Act of 1982, intercity bus operators were required to obtain an operating authority from the Interstate Commerce Commission (ICC) before providing service on a particular route. Because the ICC issued only a limited number of bus operating authorities, persons wishing to enter a route often purchased an existing bus company with the desired operating authority, paying substantial amounts for these operating authorities. Thus, the value of bus operating rights constituted a substantial part of a bus operator's assets and a source of loan collateral.

The 1982 statute greatly eased entry into the intercity bus industry. Because of this, the value of bus operating authorities has diminished significantly, to the point where they are now essentially worthless.

A deduction is allowed for any loss incurred in a trade or business during the taxable year, if the loss is not compensated for by insurance or otherwise (Code sec 165(a)). In general, the amount of the deduction equals the adjusted basis of the property giving rise to the loss (sec. 165(b)). Treasury regulations provide that, to be deductible, a loss must be evidenced by a closed and completed transaction (i.e., must be "realized"), and must be fixed by an identifiable event (Treas. Reg. sec. 1.165-1(b)).

As a general rule, no deduction is allowed for a decline in value of property absent a sale, abandonment, or other disposition. Thus, for a loss to be allowed as a deduction, generally the business must be discontinued or the property must be abandoned (Treas. Reg. sec. 1.165-2)). Further, if the property is a capital asset and is sold or exchanged at a loss, the deduction of the resulting capital loss is subject to limitations (secs. 1212, 1211, and 165(f)).

The courts have denied a loss deduction where the value of an operating permit or license decreased as the result of legislation expanding the number of licenses or permits that could be issued. In the view of several courts,[26] the diminution in the value of a license or permit does not constitute an event giving rise to a de-

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[26] *See, e.g., Consolidated Freight Lines, Inc.* v. *Comm'r*, 37 B.T.A. 576 (1938), *aff'd*, 101 F.2d 813 (9th Cir.), *cert. denied*, 308 U.S. 562 (1939) (denial of loss deduction attributable to loss of monopoly due to State deregulation of the interstate motor carrier industry); *Monroe W. Beatty*, 46 T.C. 835 (1966) (no deduction allowed for diminution in value of liquor license resulting from change in State law limiting grant of such licenses).

ductible loss if the license or permit continues to have value as a right to carry on a business.

Reasons for Change

The owners of bus operating authorities face a situation similar to that faced by owners of trucking company operating authorities after enactment of the Motor Carrier Act of 1980. That statute deregulated the trucking industry; as a result, motor carrier operating authorities lost significant value. In the Economic Recovery Tax Act of 1981, the Congress enacted a provision allowing trucking companies an ordinary deduction ratably over five years for loss in value of motor carrier operating authorities (sec. 166 of the 1981 Act).

Explanation of Provision

The bill allows an ordinary deduction ratably over a 60-month period for taxpayers who held one or more bus operating authorities on November 19, 1982 (the date of enactment of the Bus Regulatory Reform Act of 1982). The amount of the deduction is the aggregate adjusted bases of all bus operating authorities that were held by the taxpayer on November 19, 1982, or acquired after that date under a contract that was binding on that date.

The 60-month period begins with the later of November 1, 1982, or, at the taxpayer's election, the first month of the taxpayer's first taxable year beginning after that date. The bill requires that adjustments be made to the bases of authorities to reflect amounts allowable as deductions under the bill.

Under regulations to be prescribed by the Treasury, a taxpayer (whether corporate or noncorporate) holding an eligible bus operating authority would be able to elect to allocate to the authority a portion of the cost to the taxpayer of stock in an acquired corporation (unless an election under section 338 is in effect). The election would be available if the bus operating authority was held (directly or indirectly) by the taxpayer at the time its stock was acquired. In such a case, a portion of the stock basis would be allocated to the authority only if the corporate or noncorporate taxpayer would have been able to make such an allocation had the authority been distributed in a liquidation to which prior-law section 334(b)(2) applied. The election would be available only if thg stock was acquired on or before November 19, 1982 (or pursuant to a binding contract in effect on such date).

Effective Date

The provision is effective retroactively for taxable years ending after November 18, 1982. The bill extends the period of limitations for filing claims for refund or credit of any overpayment of tax resulting from this provision, if such claim is prevented on or before the date that is one year after the date of enactment of the bill. In such a case, a claim for refund or credit may be made or allowed if filed on or before the date that is six months after such date.

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by $15 million in 1986 and $5 million in 1987.

C. Other Provisions

1. Limitation on General Business Credit (sec. 631 of the bill and sec. 38 of the Code)

Present Law

The general business credit earned by a taxpayer can be used to reduce tax liability up to $25,000 plus 85 percent of tax liability in excess of $25,000. Unused credits for a taxable year may be carried back to each of the 3 taxable years preceding the unused credit year and then carried forward to each of the 15 following taxable years.

Reasons for Change

The 85 percent limit on the amount of tax which a taxpayer may offset with the investment credit enables corporations to reduce their tax liability to very low percentages of their taxable income and even lower percentages of their book income as reported to shareholders on financial statements. The Committee is concerned that this reduces confidence in the equity of the tax system.

Explanation of Provision

The limitation on the amount of income tax liability (in excess of $25,000) of an individual or corporate taxpayer that may be offset by the general business credit is reduced from 85 percent to 75 percent.[27]

Effective Date

This provision will apply to taxable years that begin after December 31, 1986.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $231 million in 1987, $302 million in 1988, $173 million in 1989, $84 million in 1990, and $37 million in 1991.

2. Regulated Investment Companies (sec. 633 of the bill and secs. 855A amd 4982 of the Code)

Present Law

In general, a regulated investment company ("RIC") is an electing domestic corporation that either meets or is excepted from cer-

[27] Additional limitations are imposed by section 1101 of the bill in the case of taxpayers with tax preferences.

tain registration requirements under the Investment Company Act of 1940 (15 U.S.C. 80), that derives at least 90 percent of its ordinary income from specified sources commonly considered passive investment income, that has a portfolio of investments that meet certain diversification requirements, that distributes at least 90 percent of its income to its shareholders annually, and that also meets certain other requirements. RICs are permitted to adopt taxable years other than a calendar year.

A RIC generally is subject to to the regular corporate tax, but receives a deduction for dividends paid to its shareholders. Dividends that are declared prior to the time that a RIC is required to file its tax return for a taxable year and that are distributed within 12 months following the close of a taxable year (but not later than the date of the first regular dividend payment made after the declaration) may be treated for purposes of the RIC's dividends paid deduction as having been paid in that taxable year (sec. 855(a)). Such dividends (called "spillover dividends") are treated as having been received by shareholders in the year of distribution (sec. 855(b)).

Reasons for Change

In the case either of a RIC that has a taxable year other than a calendar year or a RIC that distributes dividends after the close of its taxable year but elects to have the dividends treated as having been paid in the previous taxable year under section 855, significant opportunity is available for deferring recognition of currently earned income by the RIC shareholders. For example, a RIC that has a taxable year ending on January 31, earns $120 for its taxable year ending January 31, 1986. The RIC distributes $120 of dividends on January 28, 1986. If the RIC's shareholder are individuals who are calendar year taxpayers, the shareholders would include no amounts in income in their taxable years ending December 31, 1985, and include $120 in income in their taxable year ending December 31, 1986. The same result is reached if the RIC is a calendar year taxpayer, but pays dividends after the close of the taxable year that it elects to treat as being paid in the prior taxable year. As a result, in either situation, no tax is paid either by the RIC or by its shareholders in 1985 on amounts that the RIC may have earned in 1985.

The committee believes that the deferral of income described above is inconsistent with the conduit treatment that is afforded to RICs. The fundamental premise of conduit treatment is that the RIC's income should be taxed only once at the level of the RIC shareholders, rather than to the RIC. Nevertheless, in either of the cases described above, a sustantial portion of the RIC's income may go entirely untaxed in a taxable year. Accordingly, the committee believes that RICs should be required to use a calendar year as a taxable year, and that the ability of RICs to pay so-called spillover dividends without penalty should be limited.

Explanation of Provision

Under the bill, all RICs would be required to adopt a calendar taxable year (new Code sec. 855A). Existing RICs that have taxable

years other than calendar years would be required to change their taxable year to a calendar year. Consent of the Internal Revenue Service is not required for this change.

Under new section 4982, RICs that pay dividends for which an election is made under section 855 to have the dividends treated as having been paid in the prior taxable year, would be required to pay a nondeductible excise tax equal to five percent of the amount of the dividend for which the election is made.

Effective Date

The provision requiring RICs to adopt calendar taxable years is effective for taxable years beginning after December 31, 1986. Thus, a RIC's first taxable year beginning after that date would be required to end on December 31, 1987. The excise tax imposed under section 4982 is applicable to dividends paid after December 31, 1986, which, as a result of an election under section 855, are treated as having been paid in a taxable year of the RIC beginning after December 31, 1986.

Revenue Effect

The provision is expected to increase fiscal year budget receipts by less than $5 million in 1987, $1,463 million in 1988, $191 million in 1989, $210 million in 1990, and $230 million in 1991.

3. Payroll Tax Deposits (sec. 636 of the bill)

Present Law

Unless the Code specifies the mode or time for collecting a tax, it is to be collected as provided in Treasury regulations (sec. 6302). The Code does not specify the mode or time for collecting (1) income taxes withheld from employees or (2) the employee or employer FICA taxes. Consequently, the mode and time for collecting these taxes is specified in Treasury regulations (Treas. Reg. sec. 31.6302(c)-1).

Under these regulations, if the aggregate amount of undeposited taxes reaches $500 or more in any calendar month, the employer must deposit that amount in a Federal Reserve bank or authorized financial institution within 15 days of the end of that month. A different rule applies if the amount of undeposited taxes reaches $3,000 or more at the end of any one-eighth-monthly period. In this case, the employer must deposit the taxes within three banking days of the close of the one-eighth-monthly period.

Reasons for Change

The committee believes that it is desirable to increase from $3,000 to $5,000 the trigger level for the one-eighth-monthly deposit rule to alleviate the burden of frequent deposits on certain employers.

Explanation of Provision

The bill increases from $3,000 to $5,000 the amount of undeposited payroll taxes an employer may aggregate before the one-eighth-

monthly deposit rule becomes effective. No other changes are made to the section 6302 regulations or the collection requirements of present law.

Effective Date

The provision applies to months beginning after December 31, 1986.

Revenue Effect

This provision is estimated to decrease fiscal year budget receipts by $1,461 million in 1987, $519 million in 1988, $136 million in 1989, and $111 million in 1991, and to increase fiscal year budget receipts by $230 million in 1990.

TITLE VII—AGRICULTURE, ENERGY, AND NATURAL RESOURCES

A. Provisions Relating to Agriculture

1. Special Expensing and Amortization Provisions Affecting Agriculture (secs. 701 and 702 of the bill and secs. 175 and 182 of the Code)

Present Law

Expenditures for soil and water conservation

A taxpayer may elect to deduct certain expenditures for the purpose of soil or water conservation that would otherwise be added to his or her basis in the land on which the conservation activity occurs (Code sec. 175). Deductible expenditures include amounts paid for items such as grading, terracing, and contour furrowing, the construction of drainage ditches, irrigation ditches, dams and ponds, and the planting of wind breaks. Also, assessments levied by a soil or water conservation drainage district are deductible under this provision to the extent those expenditures would constitute deductible expenditures if paid directly by the taxpayer.

The cost of acquiring or constructing machinery and facilities that are depreciable may not be expensed. In the case of depreciable items such as irrigation pumps, concrete dams, or concrete ditches, the taxpayer is allowed to recover his or her cost only through cost recovery allowances and only if he or she owns the asset.

Certain costs incurred in connection with soil and water conservation are deductible as trade or business expenses without regard to section 175. For example, interest expenses and property taxes are deductible as current expenses. Similarly, the costs of repairs to a completed soil or water conservation structure are deductible as current expenses. Certain other capital expenditures made primarily to produce an agricultural crop are deductible expenses (secs. 180 and 182), but are not treated as soil or conservation expenditures under section 175, because such expenditures only incidentally may conserve soil.

The deduction for soil and water conservation expenditures under section 175 is limited in any one year to 25 percent of the gross income derived by the taxpayer from farming. Any excess amount is carried forward to succeeding taxable years.

Expenditures for clearing land

A taxpayer engaged in the business of farming may elect to treat expenditures paid or incurred in a taxable year to clear land for the purpose of making such land suitable for use in farming as currently deductible expenses (sec. 182). For any taxable year, this de-

duction may not exceed the lesser of $5,000 or 25 percent of the taxable income derived from farming.

Reasons for Change

The committee is concerned that certain Federal income tax provisions may be affecting prudent farming decisions adversely under present law. In particular, the committee is concerned that such provisions may have contributed to an increase in acreage under production, which in turn may have encouraged the present-day overproduction of agricultural commodities. The committee believes that to the extent possible, the tax code should be neutral with respect to these business decisions. To eliminate tax biases, therefore, the committee determined that certain of the special farming expensing provisions should be repealed or restricted.

Explanation of Provisions

Soil and water conservation expenditures

The bill limits the soil and water conservation expenditures that may be deducted currently to amounts incurred that are consistent with a conservation plan approved by the Soil Conservation Service (SCS) of the Department of Agriculture. If there is no SCS conservation plan for the area in which property to be improved is located, amounts incurred for improvements that are consistent with a plan of a State conservation agency are deemed to satisfy the Federal standards. Finally, the bill provides that expenditures for general earth moving, draining, and/or filling of wetlands, and for preparing land for installation and/or operation of a center pivot irrigation system may not be deducted under this special expensing provision.

Expenditures for clearing land

The bill repeals the provision allowing expenditures for clearing land in preparation for farming to be deducted currently rather than added to the basis of the land on which the activity occurs. The committee wishes to clarify, however, that routine brush clearing and other ordinary maintenance activities related to property already used in farming continue to be deductible currently to the extent the expenditures constitute ordinary and necessary business expenses of the taxpayer. (*See*, sec. 162.)

Effective Date

These provisions apply to expenditures incurred after December 31, 1986.

Revenue Effect

These provisions are estimated to increase fiscal year budget receipts by $17 million in 1987, $38 million in 1988, $35 million in 1989, $35 million in 1990, and $34 million in 1991.

2. Dispositions of Converted Wetlands and Highly Erodible Croplands (sec. 703 of the bill and new sec. 1257 of the Code)

Present Law

Gain realized on the sale or other disposition of a capital asset is subject to tax at preferential rates. The term capital asset does not include property used in a taxpayer's trade or business that is of a character subject to depreciation (sec. 1221(2)). However, gain from the sale of such property ("section 1231 assets") may be taxed on the same basis as gain from the sale of a capital asset if gains on all sales of section 1231 assets during a taxable year exceed losses on such sales.

If losses from the sale or exchange of section 1231 assets during a taxable year exceed the gains from such sales or exchanges, the net losses are treated as ordinary losses. Ordinary losses are deductible in full for tax purposes, while deductions for capital losses are subject to limitations.

Reasons for Change

The committee is concerned about the adverse environmental impact of the conversion of the nation's wetlands and erodible lands to farming uses, and wishes to discourage such conversions.

Explanation of Provision

The bill provides that to the extent section 1231 treatment otherwise is provided in the Code for such property, any gain realized on the disposition of "converted wetland" or "highly erodible cropland" will be treated as ordinary income, and any loss on the disposition of such property will be treated as long-term capital loss. For this purpose, the term "converted wetland" means land (1) that is converted wetland within the meaning of section 1201(4) of the Food Security Act of 1985 (P.L. 99-198, Dec. 23, 1985), and (2) that is held by the person who originally converted the wetland, by a person who uses the land for farming for any period of time following the conversion, or by a person whose adjusted basis in the property is determined by reference to the basis of a person in whose hands the property was converted wetland.[1] In general, the Food Security Act defines converted wetland as land that has been drained or filled for the purpose of making the production of agricultural commodities possible, if the production would not have been possible but for such action.

The term "highly erodible cropland" means any highly erodible cropland as defined in section 1201(6) of the Food Security Act that is used by the taxpayer at any time for farming purposes other than the grazing of animals. In general, highly erodible cropland is defined as land that (1) is currently classified by the Department of Agriculture as class IV, VI, VII, or VIII land under its land capability classification system, or (2) that would have an excessive av-

[1] Thus, land that has been converted could become eligible for section 1231 treatment in the hands of, for example, a subsequent purchaser or legatee, provided the purchaser or legatee has used the property only for nonfarming purposes.

erage annual rate of erosion in relation to the soil loss tolerance level, as determined by the Secretary of the Agriculture.

Effective Date

The provision is effective for dispositions of land converted after March 1, 1986.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by a negligible amount.

3. Prepayments of Farming Expenses (sec. 704 of the bill and sec. 464 of the Code)

Present Law

In general

A taxpayer generally is allowed a deduction in the taxable year which is the proper taxable year under the method of accounting used in computing taxable income (sec. 461). The two most common methods of accounting are the cash receipts and disbursements method and the accrual method. If, however, the taxpayer's method of accounting does not clearly reflect income, the computation of taxable income must be made under the method which, in the opinion of the Internal Revenue Service, clearly reflects income (sec. 446(b)). Furthermore, the income tax regulations provide that if an expenditure results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year, such an expenditure may not be deductible, or may be deductible only in part, for the taxable year in which paid by a taxpayer using the cash receipts and disbursements method of accounting, or in which incurred by a taxpayer using the accrual method of accounting (Treas. Reg. sec. 1.461-1(a)(1) and (2)).

Deductions for interest

Under the cash receipts and disbursements method of accounting, deductions generally are allowed in the year in which the expenditures are paid. Under present law, if a taxpayer uses the cash receipts and disbursements method to compute taxable income, interest paid by the taxpayer which is properly allocable to any later taxable year generally is treated as paid in the year to which it is allocable; interest is allocable to the period in which the interest represents a charge for the use or forbearance of borrowed money (sec. 461(g)). An accrual method taxpayer may deduct interest (whether or not prepaid) only in the period in which the use of money occurs. Thus, under present law, interest is deductible in the same period for both cash and accrual method taxpayers.

Deductions other than interest

Present law is unclear as to the proper timing of a deduction for prepaid expenses, other than interest. No specific statutory provision expressly permits expenses to be deducted in full when paid by a taxpayer using the cash receipts and disbursements method of ac-

counting. Such deductions are not allowed, however, to the extent that they result in a material distortion of income.

Generally, the courts have examined all the facts and circumstances in a particular case to determine whether allowing a full deduction for the prepayment would result in a material distortion of income. In determining whether an expenditure results in the creation of an asset having a useful life extending substantially beyond the end of the taxable year, the court in *Zaninovich* v. *Commissioner,* 616 F.2d 429 (9th cir., 1980), adopted a "one-year" rule. Under this rule, prepayments generally may be deducted if they do not provide benefits that extend beyond one year. Thus, under this decision, a calendar-year, cash-basis taxpayer may be able to deduct a lease payment for the next year paid in December of the current year.

Certain cash method tax shelters may not deduct expenses prior to the time when economic performance occurs (e.g., the goods are delivered or services performed). An exception is provided where economic performance occurs within 90 days of the end of the taxable year (sec. 461(.)).

Special rule for farm syndicates

Present law provides limitations on deductions in the case of farming syndicates. A farming syndicate is allowed a deduction for amounts paid for items (such as feed) only in the year in which such items are actually used or consumed or, if later, in the year otherwise allowable as a deduction. A farming syndicate is defined generally as a partnership or any other enterprise (other than a corporation which is not an S corporation) engaged in farming if (1) interests in the partnership or enterprise have been offered for sale in any offering required to be registered with any Federal or State agency or (2) if more than 35 percent of the losses during any period are allocable to limited partners or limited entrepreneurs (i.e., persons who do not actively participate in the management of the enterprise).

Reasons for Change

Many farming tax shelters operate to defer taxation of nonfarming income by prepaying farming expenses allocable to the following and subsequent years. Such tax shelters distort the measurement of taxable incomes of their investors and affect farming operations that are not established for tax reasons. In order to avoid these distortions, the committee believes that limits should be placed on the deductibility of prepaid expenses of certain farming tax shelters which do not fall within the farm syndicate rules.

However, the committee understands that, because of the seasonal nature of farming, numerous everyday business expenses are prepaid. Accordingly, the bill applies the limitations only to the extent that more than 50 percent of the farming expenses for the year are prepaid. In addition, in order to assure that farmers with continuous year-round or full-time farming activities are not subject to the limitations, the bill provides exceptions where a farmer has more than 50 percent prepaid expenses because of unusual or extraordinary circumstances. The committee believes that these

rules will limit the application of the new restrictions to cases where the abuse is serious. In addition, the committee believes that the new rules should not impose any significant additional accounting burden on farmers.

In adopting these limitations applicable to farming tax shelters, the committee does not intend to modify the rule applicable in other areas that prepaid expenses are not deductible if that deduction would result in a material distortion of income.

Explanation of Provision

Under the bill, certain taxpayers engaged in the trade as business of farming who compute taxable income under the cash receipts and disbursements method will not be allowed a deduction with respect to specified amounts paid for feed, seed, fertilizer, and other similar farm supplies earlier than the time when the feed, seed, fertilizer, or other supplies are actually used or consumed.[2]

For purposes of this provision, the trade or business of farming is defined as in section 464(c) (generally, the cultivation of land or the raising of any agricultural or horticultural commodity including animals).

The provisions of the bill generally will apply to any person engaged in the trade or business of farming to the extent that more than 50 percent of such person's farming expenses paid during the taxable year are prepaid expenses. (The bill does not, however, treat such taxpayers as farm syndicates.) For purposes of the 50 percent test, expenses will include the operating expenses of the farm such as ordinary and necessary farming expenses deductible under section 162, interest and taxes paid, depreciation allowances on farm equipment and other expenses (generally those reported on Schedule F of the taxpayer's Federal income tax return).

The bill provides two exceptions to the 50 percent test. If either of these two exceptions are met, prepaid expenses will continue to be deductible as allowed by present law, even though those prepaid expenses are greater than 50 percent of farming expenses for that year. The first exception applies if an eligible farmer fails to satisfy the 50-percent test due to a change in business operations directly attributable to extraordinary circumstances, including government crop diversion programs and circumstances described in Code section 464(d). The second exception applies if an eligible farmer satisfies the 50 percent test on the basis of the three preceding taxable years. For purposes of this exception, the expenses for the 3-year period will be aggregated. The term "eligible farmer" includes (1) any person whose principal residence is on a farm, (2) any person with a principal occupation of farming, or (3) any family member of persons described in (1) or (2). The exception applies only to an eligible farmer's farming activities attributable to the farm on which the residence is located, or to farms included in the "principal occupation" of farming activities.

The bill does not amend the farming syndicate rules of section 464, and the committee intends that this new restriction will operate independently of that provision. In addition, the committee in-

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[2] For a more detailed description of these rules, *see* section 464.

tends that farmers will not be required generally to take year-end inventories of prepaid items as a result of the provisions of this bill.

Effective Date

The provisions of the bill will apply to amounts with respect to which a deduction would be allowable under present law after March 1, 1986.

Revenue Effect

This provision will increase fiscal year budget receipts by $11 million in 1987, $24 million in 1988, $8 million in 1989, $9 million in 1990, $11 million in 1991.

4. Special Rule for Expenses Incurred In Replanting Groves, Orchards, or Vineyards Destroyed in Natural Disasters (sec. 705 of the bill and sec. 278(c) of the Code)

Present Law

Under present law, farmers may use the cash receipts and disbursements method of accounting and generally are not required to inventory costs. Farmers who adopt the cash method generally may deduct the costs of producing crops, including crops requiring more than one year to reach a productive stage, even if the costs are incurred during the preproductive period. Special rules apply to farming corporations other than certain family owned-corporations (sec. 447) and to farming syndicates (sec. 464).

In addition, special rules limit the deductibility of some costs incurred in the production of orchard, vineyard, or grove crops. Amounts paid or incurred in cultivating, maintaining, or developing citrus or almond groves before the end of the fourth taxable year after planting must be capitalized (sec. 278(a)). In general, the developmental costs of growing other such crops (including nuts other than almonds) may be deducted currently unless the taxpayer is a farming syndicate subject to section 278(b). Under section 278(b), costs incurred by a farming syndicate in planting and maintaining any grove, orchard, or vineyard must be capitalized if incurred prior to the first taxable year in which there is a crop or yield in commercial quantities.

The capitalization requirements of section 278 do not apply to deductible amounts attributable to replanting and maintenance following crop loss or damage due to freezing temperatures, disease, drought, pests, or casualty, if such loss or damage occurs while the crop was in the hands of the taxpayer (sec. 278(c)).

Reasons for Change

The committee believes that the relief provided by section 278(c) of present law for crop loss or damage is too narrowly drawn. In some cases, a farmer may be unable to restore the grove, orchard, or vineyard to its original condition without participation by outside investors. The committee believes that it is appropriate to allow relief in such situations where the farmer retains a majority

interest in the grove, orchard, or vineyard and the other persons incurring costs in connection with the replanting and maintenance materially participate in the business.

Explanation of Provision

The bill provides that if a farmer experiences loss or damage to a grove, orchard, or vineyard as a result of freezing temperatures, disease, drought, pests, or casualty, the capitalization requirements of section 278(a) and (b) do not apply to otherwise deductible costs of replanting, cultivating, maintaining, or developing the grove, orchard, or vineyard even though the costs are not incurred solely by the farmer suffering the loss, provided two conditions are met. First, the taxpayer who owned the property at the time of the loss or damage must have an equity interest of more than 50 percent in the property. Second, the additional persons incurring the costs must hold part of the remaining equity interest in the property and must materially participate in the planting, cultivation, maintenance, or development. The determination of whether an individual materially participates in an activity is made in a manner similar to that under section 2032A (relating to current use valuation of farm property).

Effective Date

The provision is effective for costs paid or incurred after the date of enactment.

Revenue Effect

The provision is estimated to decrease fiscal year budget receipts by $1 million in 1987, $6 million in 1988, $10 million in 1989, $13 million in 1990, and $13 million in 1991.

5. Treatment of Discharge of Indebtedness Income for Certain Farmers (sec. 706 of the bill and sec. 108 of the Code)

Present Law

Gross income is defined to include income from discharge of indebtedness (sec. 61). If a solvent taxpayer receives income from discharge of trade or business indebtedness, the taxpayer is permitted to exclude that income if he or she elects to reduce basis in depreciable property (secs. 108 and 1017). If the amount of the discharge of indebtedness income exceeds a solvent taxpayer's available basis, the taxpayer recognizes income in an amount of the excess.

If an insolvent taxpayer receives income from discharge of trade or business indebtedness, the taxpayer is permitted to exclude that income if the taxpayer's "tax attributes" are reduced by the amount of the income (sec. 108). Tax attributes include otherwise unused net operating loss deductions, investment tax credits, foreign tax credits, capital loss carryovers, and basis of the taxpayer's depreciable property. In the case of an insolvent taxpayer, if the amount of discharge of indebtedness income exceeds the taxpayer's available tax attributes, tax on the excess income is forgiven to the extent of the taxpayer's insolvency.

Reasons for Change

Congress has recently enacted, and presently has under consideration, measures designed to alleviate the credit crisis in the farming sector. Programs providing Federal guarantees on limited amounts of farm indebtedness in exchange for lenders reducing the total amount of a farmer's indebtedness when that farmer has a high debt to equity ratio are among the measures under consideration. The committee is concerned that farmers with high debt to equity ratios who are marginally solvent will be forced to recognize large amounts of discharge of indebtedness income as a result of these loan write-downs. Thus, the farmers may forfeit their farmland rather than participate in these new Federal farm programs designed to enable them to continue in farming.

Explanation of Provision

The bill provides that discharge of indebtedness income arising from an agreement between a solvent individual engaged in the trade or business of farming and an unrelated person to discharge qualified farming indebtedness is treated for Federal tax purposes as income realized by an insolvent individual. Qualified agricultural indebtedness is defined as debt incurred to finance the production of agricultural products (including timber) or livestock in the United States, or farm business debt secured by farmland or farm machinery and equipment used in agricultural production.

Under the provision, individuals are treated as engaged in the trade or business of farming if at least 50 percent of their average annual gross receipts during the three taxable years preceding the year in which the discharge of indebtedness occurs was derived from the trade or business of farming. Additionally, only those individuals having indebtedness equal to at least 70 percent of their total asset worth (i.e., having a 70-30 debt-equity ratio) are eligible for this special treatment.

Further, the bill includes in the list of tax attributes which may be reduced by the discharge of indebtedness income, basis in farmland; however, all tax attributes other than basis in farmland must be reduced before the discharge of indebtedness income is applied against that attribute.

Effective Date

This provision of the bill would apply to discharge of indebtedness income realized after the date of enactment of the bill, in taxable years ending after that date.

Revenue Effect

This provision will decrease fiscal year budget receipts by $9 million in 1987, $10 million in 1988, $8 million in 1989, $7 million in 1990, and $5 million in 1991.

6. Agricultural Wages Under FUTA (sec. 707 of the bill and sec. 3306 of the Code)

Present Law

Under present law, an employer is required to make tax payments under the Federal Unemployment Tax Act (FUTA) if certain requirements are met. In the case of agricultural labor, FUTA taxes must be collected if two requirements are met (Code sec. 3306(c)(1)(A)). First, the employer must have a quarterly payroll of at least $20,000. Second, the employer must have employed at least 10 employees in 20 or more days during different weeks of the year.

Reasons for Change

The objective of the two-part requirement of present law is to eliminate the recordkeeping and other burdens on smaller agricultural operations. However, the committee believes that the $20,000 quarterly payroll requirement no longer adequately achieves the goal of exempting smaller agricultural operations from FUTA tax.

Explanation of Provisions

The bill increases the quarterly payroll threshold at which agricultural wages are covered under FUTA from $20,000 to $40,000.

Effective Date

The provision is effective for wages paid after Setember 30, 1986.

Revenue Effect

The provision is estimated to decrease fiscal year budget receipts by $15 million in 1987, $21 million in 1988, $24 million in 1989, $27 million in 1990, and $29 million in 1991.

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B. Energy-Related Tax Credits and Other Incentives

1. Business Energy Tax Credits (Sec. 711 of the bill and secs. 46 and 48 of the Code)

Present Law

Business energy investment tax credits first were enacted in the Energy Tax Act of 1978, and modifications were made in the Windfall Profit Tax Act of 1980. Many of the credits that were enacted in 1978 were allowed to expire in 1982 as scheduled, and all of the remaining business energy credits were scheduled to expire after 1985. These tax credits were enacted as additions to the regular investment tax credit. They follow the general rules applicable to the investment tax credit. In almost all cases, the additional tax credit was made available for the purchase of equipment that would contribute to specified energy goals.

Solar or wind energy property

A 15-percent energy tax credit was allowed for placing in service before January 1, 1986, solar or wind energy property, which was defined to include any equipment using solar or wind energy to generate electricity, to heat or cool a structure or provide hot water for use within the structure, or to provide solar process heat. Generally, solar energy functions could be accomplished by using such equipment as collectors which absorb sunlight and create hot liquids or air, storage tanks to store hot liquids, rockbeds to store heat, thermostats to activate pumps, fans to circulate hot air, and heat exchangers. The business solar energy credit did not apply to passive solar applications. Eligible wind energy property includes such equipment as blades, rotors and turbines.

Geothermal and ocean thermal property

The 15-percent tax credit for geothermal property covered equipment used to produce, distribute, or use energy derived from a geothermal deposit, but in the case of electricity generated by geothermal power, only up to (but not including) the electrical transmission stage. The term geothermal deposit means a geothermal reservoir consisting of natural heat, which is from an underground source and is stored in rocks or in an aqueous liquid or vapor, having a temperature exceeding 50 degrees Celsius, which is 122 degrees Fahrenheit.

Energy tax credits of 15 percent also were allowed for ocean thermal property at only 2 locations. Ocean thermal property was defined as including equipment which converts ocean thermal energy through a heat exchange system into energy usable for generation of electricity. The credit was made available for equipment that could be placed in service, after appropriate application, at

either of two locations which would be designated by the Secretary of the Treasury after consultation with the Secretary of Energy. No applications have been received to date.

Biomass property

A 10-percent business tax credit was available for biomass property placed in service before January 1, 1986. In general, biomass property is defined either as (1) a boiler or burner that uses an alternate substance or (2) equipment for converting an alternate substance into a qualified fuel. An alternate substance with respect to biomass property means any property other than oil or natural gas, or any product of oil or natural gas, except that an alternate substance does not include any inorganic substance and does not include coal (including lignite) or any product of such coal. Qualified fuel is defined as any synthetic solid fuel, and alcohol for fuel purposes, if the primary source of energy for the facility producing the alcohol is not oil or natural gas (or a product of oil or natural gas).

Chlor-alkali electrolytic cells

Modifications to chlor-alkali electrolytic cells were eligible for a 10-percent energy tax credit through December 31, 1982. Certain of these projects were eligible for the energy credit beyond its expiration date, if they met specified requirements under the affirmative commitment rules. These rules provide an extension of the energy credit for projects that require two years or more for completion, if (1) all engineering studies have been completed, and all necessary construction and environmental permits have been filed for, before 1983, (2) binding contracts for 50 percent of specially designed equipment have been entered into before 1986, and (3) the project is completed and placed in service before 1991.

Reasons for Change

Business energy investment tax credits were enacted in the Energy Tax Act of 1978 and the Windfall Profits Tax Act of 1980 in order to stimulate the development and business application of a broad variety of energy sources which were perceived to be alternatives to petroleum, natural gas, and their products. Generally, the alternative methods and sources of producing energy were well known but, because of price and other advantages of fossil fuel using systems, were not experiencing widespread application. The energy tax credits were intended to increase demand for alternate energy sources, thus stimulating technological advances in production of equipment and in the design and operating efficiency of the renewable energy source.

The committee believes that it is desirable to retain energy tax credits for renewable energy sources in order to maintain an after-tax price differential between renewable and fossil fuel sources. The recent steep decline in petroleum prices has eliminated the incentive to purchase or produce renewable fuel sources and the required equipment. Without the additional stimulus from the tax credit to purchase or produce renewable fuels, the experience gained in the production and use of such fuels and the technological competence developed in their production during the past

decade will dissipate, and will not be available to call on if a fossil fuel shortage recurs.

Explanation of Provisions

Solar energy property

The business energy tax credit for solar energy systems is extended for three years at declining rates: 15 percent in 1986 and 12 percent in 1987 and in 1988. The credit will terminate after December 31, 1988. No other change is made with respect to this provision.

Geothermal energy property

The energy tax credit for geothermal energy systems is extended for a 3-year period at a declining rate: 15 percent in 1986, and 10 percent in 1987 and 1988. The credit will terminate after December 31, 1988. No other change is made in present law with respect to business geothermal energy systems.

The committee also wishes to clarify that dual purpose property which serves both qualified energy property and noqualified property will be eligible for the energy credit, if at least 50 percent of the energy used comes from qualified property. For example, 75 percent of the cost of a pipe that distributes hot water from a hot water heater, as well as hot geothermal water, would be eligible for the credit if 75 percent of the water distributed through the pipe is geothermal water. If less than 50 percent of the energy used comes from a geothermal source, the qualified investment in the property will be eligible for a partial energy credit that is equal to the percentage of geothermal source energy to the total energy used.

Ocean thermal property

The present law energy tax credit of 15 percent for equipment to convert ocean thermal energy to usable energy is extended through 1988. No other change is made with respect to this provision.

Wind energy property

The wind energy tax credit is extended through 1987 at 15 percent in 1986 and 10 percent in 1987. No other change is made with respect to this provision.

Biomass energy property

Biomass property is eligible to continue receiving the energy tax credit through 1987, at 15 percent in 1986 and 10 percent in 1987. No other change is made with respect to this provision.

Chlor-alkali electrolytic cells

The expiration date of the 10-percent energy tax credit for chlor-alkali electrolytic cells is changed from December 31, 1982, to December 31, 1983.

Effective Date

The extension and phaseout of these renewable energy tax credits is effective for expenditures made and equipment placed in serv-

ice after December 31, 1985, and before January 1, 1989, in the case of solar, geothermal and ocean thermal property, and before January 1, 1988, in the case of wind and biomass property.

Revenue Effect

The provisions relating to business energy tax credits are estimated to decrease fiscal year budget receipts by $152 million in 1986, $228 million in 1987, $89 million in 1988, and and to increase fiscal year budget receipts by $10 million in 1989, $22 milion in 1990, and $15 million in 1991.

2. Alcohol Fuels Credit and Related Excise Tax Exemptions; Import Duty (secs. 712-714 of the bill, secs. 40, 4041, 4081, and 6427 of the Code, and Item 901.50 of the Appendix to the Tariff Schedules of the U.S.)

Present Law

Alcohol fuels credit

A 60-cents-per-gallon tax credit is allowed for alcohol used in certain mixtures of alcohol and gasoline (i.e., gasohol), diesel fuel, or any special motor fuel if the mixture is sold by the producer for use as a fuel or is used as a fuel by the producer. The credit also is permitted for alcohol (other than alcohol used in a mixture with other taxable fuels) if the alcohol is used by the taxpayer as a fuel in a trade or business or is sold at retail by the taxpayer and placed in the fuel tank of the purchaser's vehicle.

The amount of any person's allowable alcohol fuels tax credit is reduced to take into account any benefit received with respect to the alcohol under the excise tax exemptions for alcohol fuels mixtures or alcohol fuels.

The credit is scheduled to expire after December 31, 1992.

Excise tax exemptions for alcohol fuels mixtures and alcohol fuels

Alcohol fuels mixtures

A 6-cents-per-gallon exemption is allowed from the excise taxes on gasoline (currently 9 cents per gallon), diesel fuel (currently 15 cents per gallon), and special motor fuels (currently 9 cents per gallon) for fuels consisting of mixtures of any of those fuels with at least 10-percent alcohol. (This is equivalent to 60 cents per gallon of alcohol in a 10-percent mixture.) The term alcohol is defined to include only alcohol derived from a source other than petroleum, natural gas, or coal. This exemption is scheduled to expire after December 31, 1992.

Alcohol fuels

A 9-cents-per-gallon exemption is allowed from the excise tax on special motor fuels for certain neat methanol and ethanol fuels derived from a source other than petroleum or natural gas. A 4-1/2-cents-per-gallon exemption is provided for these fuels when derived from natural gas. Neat alcohol fuels are fuels comprised of at least 85 percent methanol, ethanol, or other alcohol. This exemption is scheduled to expire after December 31, 1992.

Duty on imported alcohol fuels

Alcohol imported into the United States for use as a fuel is subject to an additional tariff of 60 cents per gallon from most sources. However, under the Caribbean Basin Economic Recovery Act (CBERA), such alcohol produced in a beneficiary country and imported directly into the United States from a beneficiary country is eligible for duty-free treatment. The same is true under General Headnote 3(a) of the Tariff Schedules of the United States (TSUS) for alcohol produced in U.S. insular possessions.

The CBERA established stringent rules of origin criteria to determine eligibility for duty-free treatment under the Caribbean Basin Initiative (CBI) program in order to discourage the establishment of simple pass-through operations in CBI countries. The U.S. Customs Service has ruled that the distillition of non-CBI beverage grade alcohol via the azeotropic distillation process (which in effect removes the final 5 percent of water in the alcohol bringing it from 190 proof to 199.5 proof) satisfies the substantial transformation criteria required by the CBERA for the alcohol to be considered a product of the CBI country. Therefore, the ethyl alcohol which is dehydrated/distilled in the CBI country is entitled to duty-free treatment upon import into the United States. Similar rulings have been issued with regard to alcohol imported from U.S. insular possessions.

Reasons for Change

Alcohol fuels exemptions

Alcohol fuels receive two forms of subsidy which are available either as a nonrefundable income tax credit for producers or blenders or as an excise tax exemption available for sales at the retail level of a gasoline alcohol mixture with at least 10 percent alcohol. Since their enactment, the excise tax exemptions have been used considerably more than the income tax credit because blenders or producers who may not have adequate tax liability to use all of the credits prefer to take the excise tax exemption. In addition, the excise tax exemption makes a more positive contribution to the cash flow of a cash-tight business.

Duty on imported alcohol fuel

The committee is concerned that the simple distillation process for dehydrating ethyl alcohol does not represent the type of economic activity that will increase employment and productivity in the Caribbean area in the way that was intended in the CBI program. Use of the process, instead, has become a tactic to circumvent the 60-cents-per-gallon duty and to thwart the intent of the U.S. customs laws.

Explanation of Provisions

a. Alcohol fuels credit

The 60-cents-per-gallon nonrefundable income tax credit allowed for alcohol mixed with gasoline, diesel fuel or any special motor fuel is repealed, effective after December 31, 1986.

b. Excise tax exemptions for alcohol fuels and mixtures

Gasoline and motor fuels excise tax exemptions for mixtures with alcohol and for alcohol fuels are continued in effect as in present law, with one exception. The excise tax exemption for neat ethanol and methanol fuels is reduced from 9 cents per gallon to 6 cents per gallon. As in present law, these exemptions will continue in effect until their scheduled expiration after December 31, 1992.

c. Alcohol import duty

The committee bill retains present law with respect to the 60 cents per gallon duty that is imposed on ethyl alcohol for use as a fuel that is imported into the United States. The exemption from the duty for imports of alcohol fuels from Caribbean nations, under the Caribbean Basin Initiative (CBI), is retained with a modification that will require more productive activity in the Caribbean country. Under this provision, duty-free entry into the United States is allowed only for ethyl alcohol that is produced in a CBI country or insular possession from source material which is the product of a CBI country, insular possession, or the United States. The change in the source material requirement will not apply to certain facilities which were, as of January 1, 1986, either established and operating (up to a maximum of 20 million gallons per year) or ready for shipment to and installation in a CBI country (up to a maximum of 50 million gallons per year).

Effective Dates

The repeal of the 60-cents-per-gallon credit for blenders and producers of alcohol fuels is effective after December 31, 1986.

The provision reducing the excise tax exemption for neat ethanol and methanol fuels from 9 cents per gallon to 6 cents per gallon is effective on and after January 1, 1987.

The change in the source material requirement for duty-free treatment is effective on the date of enactment.

Revenue Effect

These provisions are estimated to increase fiscal year budget receipts by less than $5 million annually.

C. Intangible Drilling Costs and Mining Exploration and Development Costs Outside the United States (secs. 715 and 716 of the bill and secs. 263, 616, and 617 of the Code)

Present Law

Intangible drilling and development costs

General rules

Under present law, intangible drilling and development costs ("IDCs") may either be deducted in the year paid or incurred ("expensed") or else may be capitalized and recovered through depletion or depreciation deductions (as appropriate), at the election of the operator. In general, IDCs include expenditures by the operator incident to and necessary for the drilling and the preparation of wells for the production of oil or gas (or geothermal energy), which are neither for the purchase of tangible property nor part of the acquisition price of an interest in the property. IDCs include amounts paid for labor, fuel, repairs, hauling, supplies, etc., to clear and drain the well site, construct an access road, and do such survey and geological work as is necessary to prepare for actual drilling. Other IDCs are paid or incurred by the property operator for the labor, etc., necessary to construct derricks, tanks, pipelines, and other physical structures necessary to drill the wells and prepare them for production. Finally, IDCs may be paid or accrued to drill, shoot, fracture, and clean the wells. IDCs also include amounts paid or accrued by the property operator for drilling or development work done by contractors under any form of contract.

Only persons holding an operating interest in a property are entitled to deduct IDCs. This includes an operating or working interest in any tract or parcel of oil, gas, or geothermal property, either as a fee owner, or under a lease or any other form of contract granting working or operating rights. In general, the operating interest in an oil or gas property must bear the cost of developing and operating the property. The term operating interest does not include royalty interests or similar interests such as production payment rights or net profits interests.

If IDCs are capitalized, a separate election may be made to deduct currently IDCs paid or incurred with respect to nonproductive wells ("dry holes"), in the taxable year in which the dry hole is completed. Thus, a taxpayer has the option of capitalizing IDCs for productive wells while expensing those relating to dry holes.

Domestic and foreign IDCs generally are subject to the same tax rules under present law.

Twenty-percent reduction for integrated producers

In the case of a corporation which is an "integrated" producer,[3] the allowable deduction with respect to IDCs that the taxpayer has elected to expense is reduced by 20 percent. The disallowed amount must instead be amortized over a 36-month period, starting with the month in which the costs are paid or incurred. Amounts paid or incurred with respect to non-productive wells (dry hole costs) remain fully deductible when the non-productive well is completed.

Mining exploration and development costs

General rules

Under present law, taxpayers may elect to expense exploration costs associated with hard mineral deposits (sec. 617). Taxpayers also may expense development costs associated with the preparation of a mine for production (sec. 616).

Mining exploration costs are expenditures for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore or other depletable mineral, which are paid or incurred by the taxpayer prior to the development of the mine or deposit. When the mine reaches the producing stage, adjusted exploration expenditures (but not development costs) either: (1) are included in income (i.e., recaptured) and recovered through cost depletion; or (2) at the election of the taxpayer, reduce depletion deductions with respect to the property. Adjusted exploration expenditures with respect to a property are expensed exploration costs attributable to the property, reduced by the excess of (1) percentage depletion which would have been allowed but for the deduction for expensed exploration costs, over (2) cost depletion for the corresponding period.[4] Exploration costs also are subject to recapture if the property is disposed of by a taxpayer after expensing these amounts (secs. 617(d)).

Development costs include expenses incurred for the development of a property after the existence of ores or other minerals in commercially marketable quantities has been determined. These costs generally include costs for construction of shafts and tunnels and, in some cases, costs for drilling and testing to obtain additional information for mining operations.

Foreign exploration costs may not be expensed to the extent that such expensing would cause the cumulative foreign and domestic exploration costs which have been expensed by the taxpayer, in the taxable year and in previous taxable years, to exceed $400,000. Exploration costs which have been expensed by persons transferring mineral properties to the taxpayer are also taken into account for this purpose.

Twenty-percent reduction for corporations

For corporations, 20 percent of exploration and development costs that the taxpayer has elected to expense are required to be

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[3] This term is defined in the same manner as it is for percentage depletion purposes (sec. 613A).

[4] Because percentage depletion deductions are limited to 50 percent of net income from the property, deductions which reduce net income (e.g., the deduction for expensed exploration costs) may reduce the value of depletion deductions.

capitalized and recovered using the schedule for 5-year accelerated cost recovery system ("ACRS") property (sec. 291). For deposits located in the United States, such expenses also qualify for the investment tax credit.

Reasons for Change

Domestic production of oil, gas, and other minerals is currently depressed and subject to serious international competition. The committee believes that the tax incentives provided for IDCs and mining expenses are appropriate only with respect to domestic exploration. Accordingly, the bill requires that IDCs and mining exploration and development costs incurred outside the United States be recovered using 10-year amortization, which is the normative recovery period for excess IDCs and mining exploration and development costs under the minimum tax, or (at the taxpayer's election) as part of the cost depletion basis.

Explanation of Provision

Under the bill, IDCs and mining exploration and development costs incurred outside the United States are recovered (1) over a 10-year straight-line amortization schedule, beginning in the year the costs are paid or incurred, or (2) at the taxpayer's election, by adding these costs to the basis for cost depletion.[5] For this purpose, the United States includes the 50 states, the District of Columbia, and those continental shelf areas which are adjacent to United States territorial waters and over which the United States has exclusive rights with respect to the exploration and exploitation of natural resources (sec. 638(1)). The 20-percent reduction for certain corporations does not apply to these costs.

Effective Date

This provision is effective for costs paid or incurred after December 31, 1986. A transitional rule is provided with respect to certain IDCs incurred in connection with North Sea oil, under a license interest acquired on or before December 31, 1985.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $4 million in 1987, $6 million in 1988, $5 million in 1989, $5 million in 1990 and $1 million in 1991.

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[5] The present law rule limiting the expensing of foreign exploration costs where cumulative expensed exploration costs exceed $400,000 (present law sec. 617(h)) remains in effect for costs paid or incurred prior to the effective date.

D. Estate and Gift Tax Deductions for Certain Qualified Conservation Contributions (sec. 717 of the bill and secs. 2055 and 2522 of the Code)

Present Law

Charitable contributions generally

Subject to certain limitations, present law permits a deduction for contributions of property to charitable organizations, to the United States, or to a State or local government. The deduction is equal to the fair market value of the property on the date of the contribution. Charitable deductions are provided for income, estate, and gift tax purposes (secs 170, 2055, and 2522).

Gifts of certain types of property interests are subject to special restrictions, either as to the amount deductible or as to the types of property interests for which a deduction is permitted. For example, a contribution of less than the donor's entire interest in property generally does not give rise to a charitable deduction (for income, estate, or gift tax purposes) unless the gift takes the form of an interest in a unitrust, annuity trust, or a pooled income fund. Exceptions are made to the partial interest restriction for gifts of remainder interests in farms or personal residences, gifts of undivided portions of the donor's entire interest in the property, and for gifts of qualified conservation interests.

Qualified conservation interests

Under present law, qualified conservation interests are real property interests donated in perpetuity for any of the following conservation purposes—

a. The preservation of land areas for outdoor recreation by, or for the education of, the general public;

b. The protection of a natural habitat of fish, wildlife, plants, or a similar ecosystem;

c. The preservation of open space (including farmland and forest land) but only if such preservation (1) either is for the scenic enjoyment of the general public, or is pursuant to a clearly delineated Federal, State, or local governmental conservation policy, and (2) will yield a significant public benefit; or

d. The preservation of an historically important land area or a certified historic structure (sec. 170(h)).

Deductible conservation interests may take any of three forms. First, the value of a remainder interest is deductible. Second, the value of a restriction (e.g., an easement) granted in perpetuity on the use of the property is deductible. Finally, the contribution of the donee's entire interest in property is deductible, except that the donor may retain his or her interest in subsurface oil, gas, or other minerals and the right of access to such minerals.

Reasons for Change

The committee is concerned that applying the same conservation purpose standards for income, estate, and gift tax deductions may cause undesirable results in certain cases. For example, under present law, if a conservation contribution is made and it later is established that the conservation purpose requirement for the contriution to be deductible is not satisfied, the donor loses his or her income tax deduction, and also may be subject to gift or estate tax. This is true nothwithstanding the fact that a charitable organization owns the property interest and the donor may not have other property or funds with which to pay the gift or estate tax.

Explanation of Provision

The bill "de-couples" the income, gift, and estate tax rules with respect to the conservation purpose requirement for claiming these deductions for qualified conservation contributions. The requirement of a conservation purpose is retained as under present law for the income tax rules; however, the bill provides that contributions that are determined not to satisfy that requirement will nonetheless not result in imposition of gift or estate tax.

Effective Date

This provision is effective for gifts of qualified conservation contributions made after December 31, 1986.

Revenue Effect

This provision is estimated to reduce fiscal year budget receipts by less than $5 million annually.

TITLE VIII—FINANCIAL INSTITUTIONS

A. Reserves for Bad Debts for Thrift Institutions (Sec. 801 of the bill and sec. 593 of the Code)

Present Law

In general

Under present law, taxpayers are allowed a deduction for debts that become uncollectible during the taxable year (i.e., the "specific charge-off method") or a deduction for reasonable additions to a reserve for bad debts (i.e., the "reserve method"). In the case of mutual savings banks, domestic building and loan associations, and cooperative banks without capital stock that are organized and operated for mutual purposes and without profit (collectively called "thrift institutions"), the reasonable addition to the reserve for bad debts is equal to the addition to the reserve for losses computed under the "experience" method, the "percentage of eligible loans method" or, if a sufficient percentage of the thrift institution's assets constitute "qualified assets," the "percentage of taxable income" method.

Experience method

The experience method for thrift institutions is the same as the experience method allowed for banks by section 585(b)(3). Under this method, an annual deduction is allowed for the amount necessary to increase the reserve for bad debts account to its maximum allowed ending balance. The maximum allowed ending balance is that portion of the balance of loans outstanding at the end of the year that the total bad debts in the current and five preceding taxable years (a shorter period may be used with the approval of the Secretary) bears to the sum of the loans outstanding at the close of each of those years. However, the ending reserve balance need not be reduced to an amount less than the balance in the reserve at the close of the base year (the last taxable year before the most recent adoption of the experience method) so long as the amount of total loans outstanding at the close of the current taxable year are at least as great as the amount of total loans outstanding at the close of the base year.

Percentage of eligible loans method

The percentage of eligible loans method for thrift institutions is the same method as allowed for banks by section 585(b)(2). Under this method, as under the experience method, an annual deduction is allowed for the amount necessary to increase the reserve for bad debts account to its maximum allowed ending balance. The maximum allowed ending balance is 0.6 percent of eligible loans out-

standing at year end.[1] Eligible loans do not include loans on which there is considered to be an insubstantial risk of loss.[2]

As under the experience method, a maximum ending reserve balance equal to the base year reserve is allowed so long as eligible loans have not decreased from their balance in the base year.

The percentage of eligible loans method is not available for taxable years beginning after 1987.

Percentage of taxable income method

Under the percentage of taxable income method, an annual deduction is allowed for a statutory percentage of taxable income.[3] The statutory percentage for tax years beginning after 1978 is 40 percent.

The full 40 percent of taxable income deduction is available only where 82 percent (72 percent in the case of mutual savings banks without capital stock) of the thrift institution's assets are qualified. Qualifying assets include cash; obligations and securities of governmental entities including corporations that are instrumentalities of governmental entities; obligations of State corporations organized to insure the deposits of members; loans secured by a deposit or share of a member; loans secured by residential or church real property and residential and church improvement loans; loans secured by property or for the improvement of property within an urban renewal area; loans secured by an interest in educational, health or welfare institutions or facilities; property acquired through defaulted loans on residential, church, urban development or charitable property; educational loans; and property used in the business of the association.

If a thrift institution, other than a mutual savings bank, fails to meet the 82-percent qualified assets test, the statutory rate is reduced by three-fourths of one percentage point for each one percentage point of such shortfall.[4] For mutual savings banks without capital stock, the statutory rate is reduced by 1-1/2 percentage points for each percentage point that qualified assets fail to reach the 72-percent requirement. At a minimum, 60 percent of a thrift institution's assets must be qualified assets (50 percent for mutual savings banks without stock) in order to be eligible for deductions under the percentage of income method.

The deduction for any year under the percentage of income method cannot exceed the amount by which 12 percent of the total deposits or withdrawable accounts of the depositors of the thrift institution at the close of the taxable year exceeds the sum of the thrift institution's surplus, undivided profits, and reserves at the beginning of such year.

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[1] For taxable years beginning after 1975, but before 1982, the percentage was 1.2 percent. For taxable years beginning in 1982, the percentage was 1.0 percent.

[2] Loans specifically excluded from the definition of eligible loans are listed in section 585(b)(4).

[3] For purposes of determining the deduction under the percentage of income method, taxable income is computed without regard to any deduction allowable for any addition to the reserve for bad debts and exclusive of 18/46 of any net long-term capital gain, gains on assets the interest on which was tax-exempt, any dividends eligible for the corporate dividends received deduction and any additions to gross income from the thrift institution's own distributions from previously accumulated reserves.

[4] For example, consider a thrift institution (other than a mutual savings bank) that has only 75 percent of its assets in qualified assets. The shortfall is 7 percentage points, so the statutory rate is reduced by 5-1/4 percentage points to 34-3/4 percent of taxable income.

A thrift institution may switch between methods of determining the addition to its bad debt reserve from one year to another. Such a change does not, however, result in a change in the balance in the bad debt reserve account at the beginning of the year in which the change occurs.

Under present law, if the bad debt reserve deduction for the taxable year determined under the above rules exceeds the amount that would have been allowed as a deduction on the basis of actual experience, the deduction is reduced by 20 percent of such excess. Also, 59-5/6 percent of the deductible excess (after the 20-percent reduction) is treated as a tax preference for purposes of computing the corporate minimum tax (sec. 57).

Reasons for Change

Since the last time that Congress has reviewed the taxation of thrift institutions and other financial institutions, there have been several changes in regulatory policies that have expanded the activities in which thrift institutions may engage, and at the same time encouraged other institutions to expand their activities in areas that were traditionally serviced by the thrift institutions. These changes have resulted in other financial institutions being in direct competition with thrift institutions, while present law provides significantly different tax treatment of these financial institutions.[5] Such policies are not promoted by providing a substantially lower effective tax rate for one competitor than for others.

Accordingly, the committee believes that present law, which allows a bad debt deduction to thrift institutions equal to 40 percent of taxable income, should be substantially reduced. Nonetheless, the committee continues to believe that there should be some incentive for thrift institutions to provide residential mortgage loans.

Explanation of Provision

The bill reduces the percentage of taxable income that thrift institutions (mutual savings banks, domestic building and loan associations, and cooperative banks) using the percentage of taxable income method may exclude from taxable income as an addition to reserves for bad debts from 40 percent to 25 percent.

The rules reducing the amount of the percentage of taxable income deduction available to a thrift institution that holds 60 percent of its assets in qualifying assets, but fails to hold a sufficient percentage of qualifying assets to use the maximum percentage of taxable income adjustment are changed. A thrift institution other than a mutual savings bank will reduce the maximum 25 percent of taxable income deduction by one-half of one percentage point for each full percentage point by which its qualified assets fall below 82 percent of total assets. A mutual savings bank will reduce the

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[5] The effect of the present-law 40-percent deduction, in combination with the 20-percent disallowance for corporate preferences, is to provide a maximum effective tax rate of 31.28 percent to thrift institutions, while other corporations are subject to a maximum effective tax rate of 46 percent. The effect of continuing the 40-percent deduction and the 20-percent disallowance for corporate preferences in combination with the 33-percent maximum corporate rate in the bill would have been to provide a maximum tax rate of 22.44 percent to thrift institutions.

maximum 25 percent of taxable income deduction by a full percentage point for each percentage point by which its qualified assets fall below 72 percent of total assets.

For example, a domestic building and loan association holds 62 percent of its assets in qualifying assets. The maximum bad debt deduction that it may take using the percentage of taxable income method is 15 percent, since it must reduce the maximum percentage allowed by one-half percentage point for each of the twenty percentage points by which it fails to meet the 82 percent of qualifying assets required to obtain the maximum deduction. A mutual savings bank would likewise take a deduction equal to 15 percent of taxable income, having reduced the maximum 25 percent by a full percentage point for each of the ten percentage points by which it fails to meet the 72 percent of qualifying assets required of it to obtain the maximum deduction.

In addition to the percentage of taxable income method, thrift institutions may continue to use the experience method of computing losses from bad debts that is allowed to banks by section 585. Thrift institutions also may use the percentage of eligible loans method for taxable years beginning before 1988.

Effective Date

The provision is effective for taxable years beginning after December 31, 1986.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $55 million in 1987, $90 million in 1988, $98 million in 1989, $113 million in 1990, and $130 million in 1991.

B. Special Rules for Net Operating Losses of Depository Institutions (Sec. 802 of the bill and sec. 172 of the Code)

Present Law

Under present law, most taxpayers are permitted to carry net operating losses back to the prior three taxable years and forward to the succeeding fifteen taxable years (or a total of eighteen years). Under a special rule, financial institutions, including mutual savings banks, domestic building and loan associations, and cooperative banks, may carry net operating losses back to the prior ten taxable years and forward to the succeeding five taxable years (or a total of fifteen years).

Reasons for Change

In the early 1980s, many thrift institutions incurred large net operating losses. In many situations, these net operation losses resulted from the deregulation of the these institutions. Under the present law rules, many of these losses will expire in the near future. The committee is concerned that the potential inability of thrift institutions to otherwise utilize their net operating losses against taxable income may not be in the best interests of the economy. Such institutions may engage in overly risky activities in an attempt to generate sufficient taxable income to offset the net operating losses or may be pressured to reorganize with other taxpayers where the reorganized entity can use the net operating losses within the present law carryforward period.

The committee believes that an extension of the carryforward period by an additional three years is a preferable approach to encouraging overly risky activities or reorganizations that are motivated by tax rather than economic considerations. The committee believes that an additional three-year carryforward period is appropriate because the three additional years would permit a total carryover period (i.e., eighteen years) equal to that available to taxpayers generally. The committee believes that the additional carryforward period should be available only with respect to losses incurred during taxable years beginning during the period 1982 to 1985. The committee believes that this limited transition period is appropriate as thrift institutions recover from the change in the regulatory rules which caused the net operating losses.

Explanation of Provision

The bill provides that net operating losses incurred by a thrift institution (i.e., mutual savings banks (including savings banks with stock which are treated as mutual savings banks under sec. 591(b)), domestic building and loan associations, and cooperative banks) in taxable years beginning after December 31, 1981, and

before January 1, 1986, may be carried back to the prior ten years and carried forward to the succeeding eight years. The carryover period for net operating losses incurred by thrift institutions in other years is not affected.

Effective Date

The provision is effective as of the date of enactment of the bill.

Revenue Effect

The provision is estimated to decrease fiscal year budget receipts by $62 million in 1988, $98 million in 1989, $97 million in 1990, and $81 million in 1991.

C. Treatment of Losses on Deposits in Insolvent Financial Institutions (sec. 803 of the bill and sec. 165 of the Code)

Present Law

Under present law, a loss experienced by a taxpayer with respect to a deposit in a financial institution is treated in the same manner as any other type of bad debt loss. Deduction of the loss is generally allowable only in the year in which it is determined (based on all the facts and circumstances) that there is no prospect of recovery. Unless the deposit in the financial institution was created or acquired in connection with a trade or business of the taxpayer, any loss on the deposit will be considered a short-term capital loss (sec. 166(d)). An individual taxpayer may generally deduct short-term capital losses only to the extent of $3,000 plus his capital gains for the year (sec. 1211).

Reasons for Change

The committee believes that the circumstances surrounding deposits in financial institutions are different from the circumstances surrounding other debts owed to a taxpayer. Depositors in financial institutions often use such accounts for temporary safekeeping of funds that are needed for food, rent, and other essential items, rather than for investment. In most cases, these funds were deposited with the expectation that they could be withdrawn on demand.

The committee believes that an individual should be allowed an election to deduct the loss arising from the insolvency of a financial institution at the time that the loss becomes reasonably estimable. The committee also believes that the loss may be better viewed as a casualty loss than as a short-term capital loss, and should be entitled to casualty loss treatment for Federal income tax purposes.

Explanation of Provision

The bill allows qualified individuals to elect to deduct losses on deposits in qualified financial institutions as casualty losses in the year in which the amount of such loss can be reasonably estimated. If a qualified taxpayer elects to treat a loss on a deposit in a qualified financial institution as a casualty loss, no deduction for the loss as a bad debt under the provisions of section 166 will be available. The election will constitute an election of a method of accounting with regard to all deposits in the same institution, and will require any loss on such other deposits to be treated in the same manner unless the permission of the Commissioner of Internal Revenue is obtained to use a different method.

A qualified individual is any individual other than an owner of one percent or more of the value of the stock of the institution in

which the loss was sustained, an officer of such institution, and certain relatives and related persons to such owners and officers. Relatives of one-percent owners and officers who will not be considered as qualified individuals are siblings (whether by whole or half blood), spouses, aunts, uncles, nephews, nieces, ancestors, and lineal descendants. An individual will be considered to be a related person of a one-percent owner or officer if he would be considered a related person under the provisions of section 267(b).

A qualified financial institution is any commercial bank (as defined in sec. 581), any thrift institution (as defined in sec. 591), any insured credit union, or any institution similar to the above which is chartered and supervised under Federal or State law. A deposit for the purposes of this provision is any deposit, withdrawable certificate, or withdrawable or repurchasable share of or in a qualified financial institution.

The amount of loss to be recognized in any year under the election is intended to be the difference between the taxpayer's basis in the deposit and the amount which is a reasonable estimate of the amount that will eventually be received with regard to such deposit. A reasonable estimate of the amount that will eventually be received might, for example, be based on a determination by an agency having regulatory authority over the financial institution as to the percentage of total deposits that the institution (or its insurer) is likely to honor.

It is not intended that the failure of a taxpayer to claim a loss under this provision in the year in which such loss can first be reasonably estimated will preclude the taxpayer from claiming such loss in a later year, either under this election or as a bad debt under section 166.

If a loss that has been claimed under this election is later recovered, the committee anticipates that the taxpayer will be required to include the amount thereof in income in the year of such recovery, under normally applicable tax benefit principles.

Effective Date

The provision is effective for taxable years beginning after December 31, 1982.

Revenue Effect

The provision is estimated to decrease fiscal year budget receipts by $3 million in 1987, $1 million in 1988, $1 million in 1989, $1 million in 1990, and $1 million in 1991.

TITLE IX—FOREIGN TAX PROVISIONS

A. Foreign Tax Credit (secs. 901 through 905 of the bill and secs. 901, 902, 904, and 960 of the Code)

Present Law

Foreign tax credit

The United States taxes U.S. persons on their worldwide income, including their foreign income. Congress enacted the foreign tax credit in 1918 to prevent U.S. taxpayers from being taxed twice on their foreign income—once by the foreign country where the income is earned, and again by the United States. The foreign tax credit generally allows U.S. taxpayers to reduce the U.S. tax on their foreign income by the foreign income taxes they pay on that income.

A foreign tax credit is allowed for foreign taxes paid on income derived from direct operations (conducted, for example, through a branch office) or passive investments in a foreign country. A credit also is allowed with respect to dividends received from foreign subsidiary corporations operating in foreign countries and paying foreign taxes. The latter credit, which is discussed in more detail below, is called a deemed-paid credit or an indirect credit.

Creditability rules and withholding taxes on interest

The foreign tax credit is available only for income, war profits, and excess profits taxes paid to a foreign country or a U.S. possession and for certain taxes imposed in lieu of them (Code secs. 901 and 903). Other foreign levies generally are treated as deductible expenses only. To be creditable, a foreign levy must be the substantial equivalent of an income tax in the U.S. sense, whatever the foreign government that imposes it may call it.[1] To be considered an income tax, a foreign levy must be directed at the taxpayer's net gain.[2]

Treasury regulations promulgated under Code sections 901 and 903 provide detailed rules for determining whether a foreign levy is creditable (Treas. Reg. secs. 1.901-1 through 1.901-4 and 1.903-1). In general, a foreign levy is creditable only if the levy is a tax and its predominant character is that of an income tax in the U.S. sense. A levy is a tax if it is a compulsory payment under the authority of a foreign country to levy taxes and is not compensation for a specific economic benefit provided by a foreign country such as the right to extract petroleum owned by the foreign country. The predominant character of a levy is that of an income tax in the U.S. sense if the levy is likely to reach net gain in the normal circum-

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[1] Biddle v. Commissioner, 302 U.S. 573 (1938).

[2] Bank of America National T. & S. Association v. United States, 459 F.2d 513 (Ct. Cl. 1972).

stances in which it applies and the levy is not conditioned on the availability of a foreign tax credit in another country (a levy that is so conditioned is referred to as a "soak-up" tax).

Taxpayers who are subject to a foreign levy and also receive a specific economic benefit from the levying country are referred to as dual capacity taxpayers under the regulations. Dual capacity taxpayers may obtain a credit only for that portion of the foreign levy that they can establish was not compensation for the specific economic benefit received. A specific economic benefit is any economic benefit that is not made available on substantially the same terms to substantially all persons who are subject to the income tax that is generally imposed by the levying country, or, if there is no such generally imposed income tax, any economic benefit that is not made available on substantially the same terms to the population of the country in general. An economic benefit includes property; a service; a fee or other payment; a right to use, acquire or extract resources, patents or other property that a foreign country owns or controls; or a reduction or discharge of a contractual obligation. It does not include the right or privilege merely to engage in business generally or to engage in business in a particular form.

A foreign levy is a creditable tax "in lieu of" an income tax under the regulations only if the levy is a tax and is a substitute for, rather than an addition to, a generally imposed income tax. A foreign levy may satisfy the substitution requirement only to the extent that it is not a soak-up tax.

The current regulations generally test the creditability of gross withholding taxes on interest under the "in lieu of" creditability rules of section 903 rather than under the general creditability rules of section 901. Such withholding taxes generally were tested for creditability under section 901 under prior regulations.

An earlier version of the regulation governing "in lieu of" taxes (Temp. Treas. Reg. sec. 4.903-1, T.D. 7739, filed November 12, 1980) required that a foreign levy be comparable in amount to the amount that would have been paid on the income involved had the general income tax of the levying country (or U.S. possession) applied to that income. The Treasury Department omitted the comparability rule from the final regulations after concluding that the statutory language of section 903 probably did not grant the IRS sufficient authority to promulgate such a rule.

The foreign tax credit for taxes on foreign oil related income *is* limited by a comparability rule under present law (Code sec. 907(b)). Under this comparability rule, a foreign tax on oil related income is noncreditable to the extent that the Secretary determines that the foreign law imposing the tax is structured, or in fact operates, so that the amount of tax imposed with respect to foreign oil related income will generally be materially greater, over a reasonable period of time, than the amount generally imposed on income that is neither foreign oil related income nor foreign oil and gas extraction income.

Treasury regulations allow a credit only for that amount of an income tax or "in lieu of" tax that is paid to a foreign country by the taxpayer. The Treasury regulations provide that the "taxpayer" is the person upon whom foreign law imposes legal liability for a tax. However, a tax is considered paid by the taxpayer even if

another party to a transaction with the taxpayer agrees, as a part of the transaction, to assume the taxpayer's liability for the tax. Foreign borrowers frequently pay interest on loans from U.S. lenders "net" of income taxes. That is, the borrowers promise the lenders a certain after-foreign tax interest rate on the loans and agree to assume the lenders' liability for any foreign taxes imposed. The borrower may pay the taxes directly, pay additional interest to the lender equal to the tax the lender must pay, or reimburse the lender directly for the tax the lender pays. In general, under the regulations, foreign taxes paid by foreign borrowers pursuant to such arrangements are creditable in full by the U.S. lenders: the taxes are considered paid by the lenders notwithstanding that the foreign borrowers agree to pay them, provided that the levying country does not refund or otherwise forgive the taxes. However, in certain cases where the foreign borrower is a foreign government or is owned by a foreign government present law may be unclear regarding whether foreign taxes are creditable in full by the U.S. lender.

Under the Treasury regulations on creditability, a tax is not "paid" to a foreign country to the extent that it is reasonably certain to be refunded, credited, rebated, abated, or forgiven (Treas. Reg. sec. 1.901-2(e)(2)). To encourage foreign lenders to lend to their residents, some countries have attempted to subsidize foreign loans to their residents by rebating to their residents, directly or indirectly, all or a portion of the withholding taxes that the countries impose on the interest paid on loans from foreign lenders. Since the taxes are not formally rebated to the lenders, some U.S. lenders argue that they have "paid" the taxes and, therefore, should be granted foreign tax credits for them. The regulations disallow foreign tax credits in these cases, however. Under the regulations, a tax is not "paid" to a foreign country if it is used directly or indirectly as a subsidy to the taxpayer or certain related persons (Treas. Reg. sec. 1.901-2(e)(3)).

Foreign tax credit limitation

A premise of the foreign tax credit is that it should not reduce a taxpayer's U.S. tax on its U.S. income, only a taxpayer's U.S. tax on its foreign income. Permitting the foreign tax credit to reduce U.S. tax on U.S. income would in effect cede to foreign countries the primary right to tax income earned in the United States.

The tax law imposes a limitation (first enacted in 1921) on the amount of foreign tax credits that can be claimed in a year that prevents a taxpayer from using foreign tax credits to offset U.S. tax on U.S. income. This limitation generally is calculated by prorating a taxpayer's pre-credit U.S. tax on its worldwide taxable income (U.S. and foreign taxable income combined) between its U.S. and foreign taxable income. The ratio of the taxpayer's foreign taxable income to its worldwide taxable income is multiplied by the taxpayer's total pre-credit U.S. tax to establish the amount of U.S. tax allocable to the taxpayer's foreign income and, thus, the upper limit on the foreign tax credit for the year.

Overall and per country limitations

Historically, the foreign tax credit limitation has been determined on the basis of total foreign income (an "overall" limitation or method), foreign income earned in a particular country (a "per country" limitation or method), or both.

Under an overall method, the taxpayer adds up its net income and net losses from all sources outside the United States and allocates its pre-credit U.S. tax based on the total. An overall method permits "averaging" for limitation purposes of the income and losses generated in, and the taxes paid to, the various foreign countries in which a taxpayer operates and other income and losses sourced outside the United States. An overall method also permits averaging of tax rates applied to different types of income—active and passive, for example.

Under a per country method, the taxpayer calculates the foreign tax credit limitation separately for each country in which it earns income. The foreign income taken into account in each calculation is the foreign income derived from the foreign country for which the limitation is being determined. Otherwise, a per country limitation is calculated in basically the same manner as an overall limitation.

Under a per country limitation, foreign taxes paid on income from sources within any particular foreign country can be used as credits by the taxpayer only against that portion of its total pre-credit U.S. tax that is allocable to that income. Thus, a per country limitation restricts the averaging of tax rates applied by different foreign countries. However, under prior law per country rules, some intercountry averaging could continue to be achieved through the use of a foreign holding company because earnings and taxes were not traced through tiered entities located in different foreign countries.

From 1921 until 1932, an overall limitation was in effect. Between 1932 and 1954, foreign tax credits were limited to the lesser of the overall or per country limitation amount. In 1954, Congress amended the law to allow only a per country limitation. From 1960 to 1975, Congress permitted taxpayers to elect between an overall and a per country method. Since 1976, an overall limitation has been mandatory.

The per country limitation rules of prior law permitted a taxpayer first to use the entire amount of a net loss incurred in any foreign country to reduce its U.S. taxable income. The taxpayer received a second tax benefit when in a later year, it earned income in the loss country and that country imposed tax on the income at a rate higher than the U.S. rate and had no net operating loss carryforward provision. A full foreign tax credit was allowed for that tax, eliminating the U.S. tax on the income, even though the earlier loss had reduced U.S. taxable income and, thus, U.S. tax, also. Congress repealed the per country limitation in 1976 to eliminate this double tax benefit.

Separate limitations

The overall foreign tax credit limitation is calculated separately for DISC dividends, FSC dividends, taxable income of a FSC attrib-

utable to foreign trade income, and passive interest income, respectively (sec. 904(d)). Also, a special limitation applies to the credit for taxes imposed on oil and gas extraction income (sec. 907(a)).

In general, the separate limitation for passive interest income applies to any interest other than the following: interest derived from any transaction which is directly related to the active conduct of a trade or business in a foreign country or a U.S. possession; interest derived in the conduct of a banking, financing, or similar business; or interest received on obligations acquired as a result of the disposition of a trade or business actively conducted in a foreign country or U.S. possession or as a result of the disposition of stock or obligations of a corporation in which the taxpayer owned at least 10 percent of the voting stock.

The separate limitation for passive interest generally does not apply to interest received from a corporation in which the taxpayer (or one or more includible corporation in an affiliated group of which the taxpayer is a member) owns, directly or indirectly, at least 10 percent of the voting stock. However, under the Tax Reform Act of 1984, the separate limitation does apply to subpart F and foreign personal holding company inclusions of, and dividends and interest received by, a U.S. person that are attributable to separate limitation interest income of a 10-percent U.S.-owned foreign corporation or a regulated investment company.

Under the special limitation for oil and gas extraction income, otherwise creditable amounts claimed as taxes paid on foreign oil and gas extraction income of a U.S. company may be credited only to the extent that they do not exceed the highest U.S. corporate tax rate multiplied by the amount of such extraction income. Payments in excess of this limitation generally may be carried back and forward and credited against the U.S. tax otherwise due on extraction income earned in the carryback and carryforward years.

A separate or special limitation generally is applied to a category of income for one of three reasons: the income's source (foreign or U.S.) can be manipulated; the income typically bears little or no foreign tax; or the income often bears a rate of foreign tax that is abnormally high or in excess of rates on other types of income. Applying a separate limitation to a category of income prevents the averaging of that income, and the foreign taxes paid on it, with other types of income, and the foreign taxes paid on the other income.

For example, under the separate limitation for passive interest, high foreign taxes paid on manufacturing income generally do not reduce the U.S. tax on interest income that is lightly taxed abroad. Similarly, under the special limitation for oil and gas extraction income, foreign levies on oil and gas extraction income of a corporation, to the extent that they exceed the highest U.S. tax that can apply to such income, cannot reduce the U.S. tax on lightly taxed, nonextraction income. Separate limitations help to preserve the U.S. tax on foreign income that frequently bears little or no foreign tax while at the same time ensuring that double taxation is relieved with respect to all categories of income.

Passive income is relatively manipulable with respect to source and tends to be lightly taxed abroad. One example is dividends paid on portfolio stock investments. Just as the source of passive

interest income can be shifted by making an investment in a foreign bank rather than in a U.S. bank, the source of portfolio dividend income can be shifted by buying stock of a foreign corporation rather than stock of a U.S. corporation. However, under present law, the only passive income subject to a separate limitation is interest. Thus, under present law, a multinational entity can, for example, average foreign manufacturing income earned in a high tax country with passive royalty income that bears little or no foreign tax.

Present law also allows a U.S. lender to use foreign tax credits granted for high foreign withholding taxes on interest to eliminate not only the lender's U.S. tax liability on the net interest income from the associated loans, but also the lender's U.S. tax liability on other income it earns from the same foreign country or from other sources outside the United States.

Deemed-paid credit

U.S. corporations owning at least 10 percent of the voting stock of a foreign corporation are treated as if they had paid a share of the foreign income taxes paid by the foreign corporation in the year in which that corporation's earnings and profits become subject to U.S. tax as dividend income of the U.S. shareholder. This is the "deemed-paid" or "indirect" foreign tax credit.

Earnings and profits of a foreign corporation are generally not subject to U.S. tax as dividend income of a U.S. shareholder until repatriated through an actual dividend distribution. However, the rules of subpart F of the Code (discussed further below) treat certain undistributed earnings and profits of a controlled foreign corporation as a current income inclusion of U.S. shareholders who own 10 percent or more of the voting stock (taking into account attribution rules). A deemed-paid credit is also generally available to the U.S. shareholder with respect to such inclusions.[3]

In the case of an actual dividend distribution, the share of foreign tax paid by the foreign corporation that is eligible for the indirect credit is based on the share of that corporation's accumulated profits that is repatriated as a dividend to the U.S. corporate shareholder. Foreign taxes paid for a particular year are eligible for the indirect credit only to the extent that there are accumulated profits for that year and then only in proportion to the share of such accumulated profits that is attributed to the dividend distribution. Distributions are considered made first out of the most recently accumulated profits of the distributing corporation. Distributions made during the first 60 days of a taxable year are treated as paid out of the prior year's accumulated profits. The IRS has ruled that a foreign corporation's deficit in earnings and profits in any year reduces the most recently accumulated earnings and profits of prior years for purposes of matching prior years' foreign taxes with accumulated profits. Rev. Rul. 74-550, 1974-2 C.B. 209.[4]

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[3] Unlike the deemed-paid credit for actual dividend distributions, the deemed-paid credit for subpart F inclusions can be available to individual shareholders in certain circumstances if an election is made.

[4] Compare Champion International Corp., 81 T.C. 424, 442 (1983); Pacific Gamble Robinson Co. v. U.S., 62-1 USTC Para. 9160 (W.D. Wash. 1961).

In the case of an income inclusion under subpart F, foreign taxes paid by the foreign corporation for the taxable year are eligible for the indirect credit only in proportion to the share of the controlled foreign corporation's earnings and profits of the year that is attributed to the subpart F inclusion.

For either an actual distribution or a subpart F inclusion, the amount of foreign tax eligible for the indirect credit is computed as a fraction of the foreign tax paid by the foreign corporation. The numerator of the fraction is the U.S. corporate shareholder's actual dividend or subpart F inclusion income from the foreign corporation. The denominator is the foreign after-tax accumulated profits (in the case of an actual dividend) or earnings and profits (in the case of a subpart F inclusion) attributed to the taxable year of the foreign tax. (The amount of foreign tax thus eligible for the indirect credit is also "grossed-up" and included in the U.S. corporate shareholder's income to treat the shareholder as if it had received its proportionate share of pre-tax profits and paid its proportionate share of foreign tax).[5]

Under this formula for computing the indirect credit, for any given dividend amount in the numerator of the fraction, a greater amount of accumulated profits (or earnings and profits) in the denominator of the fraction produces a smaller amount of foreign taxes allowed as a credit.

Both accumulated profits of a foreign corporation in the case of actual dividend distributions [6] and earnings and profits of the foreign corporation in the case of a subpart F inclusion (sec. 964(a)) are generally calculated in accordance with the principles governing the calculation of earnings and profits for U.S. tax purposes.

However, accumulated profits as calculated for purposes of the indirect credit with respect to actual distributions, and earnings and profits as calculated for purposes of the indirect credit with respect to subpart F inclusions may differ in several respects. For example, the subpart F rules (which Treasury regulations allow a U.S. corporate shareholder to elect to apply to actual distributions from a controlled foreign corporation) do not require adjustment to U.S. financial and tax accounting principles if the adjustment is not "material." In addition, different foreign currency translation rules for actual and for subpart F deemed distributions are mandatory.

In the case of an actual dividend distribution, the first-tier foreign corporation making the distribution is generally deemed to have paid a proportionate share of the foreign taxes paid by a second-tier foreign corporation of which it owns at least 10 percent of the voting stock, and the same principle applies between a second and a third-tier foreign corporation; provided (in the case of

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[5] For example, assume a foreign subsidiary earns $100 of income on which it pays $30 of foreign income tax. If a $35 dividend were paid (or if there were a $35 income inclusion under subpart F) out of the $70 of after-tax earnings, the U.S. shareholder would have a $15 indirect foreign tax credit (35/70 x $30) and $50 of income ($35 + $15). The "gross-up" prevents the U.S. corporate taxpayer from effectively obtaining a deduction as well as a credit for foreign taxes, since the amount of the actual distribution or subpart F inclusion reflects only after-foreign tax profits.

[6] Steel Improvement & Forge Co., 36 T.C. 265 (1961); rev'd on another issue 314 F. 2d 96 (6th Cir. 1963); Rev. Rul. 63-6, 1963-1 C.B. 126; Treas. Reg. 1.902-1(e); see H.H. Robertson Co., 59 T.C. 56 (1972), aff'd in unpublished opinion (3d Cir., July 24, 1974).

a second or third-tier foreign corporation) that the product of the percentage ownership at each level equals at least 5 percent. Foreign taxes paid below the third-tier are not eligible for the deemed-paid credit.

Subpart F inclusions are deemed included directly in the income of the U.S. shareholder. For example, a subpart F inclusion from a second- or third-tier foreign subsidiary is not treated as passing through any upper-tier corporation; rather, it is an inclusion directly from the lower-tier subsidiary. Thus, the foreign taxes and earnings and profits of that subsidiary are undiluted by and are not averaged with those of any upper-tier company in determining the deemed-paid credit. The credit is not available, however, for inclusions from subsidiaries below the third tier. Percentage ownership requirements, similar to those applicable in the case of actual dividends, apply in order for inclusions from lower-tier subsidiaries to qualify for the deemed-paid credit.

For purposes of the excess credit carryback and carryover provisions, foreign taxes eligible for the deemed-paid credit are considered paid in the year the U.S. corporation includes the related dividend in income, regardless of when the taxes were paid to the foreign country.

Foreign losses

If a taxpayer's foreign losses exceed its foreign income, the excess ("overall foreign loss") reduces the taxpayer's U.S. taxable income and, hence, its U.S. tax. To eliminate a double benefit (that is, the reduction of U.S. tax just noted and, later, full allowance of a foreign tax credit with respect to foreign income), the overall foreign loss recapture rule was enacted in 1976. Under this rule, a portion of foreign taxable income earned after an overall foreign loss year is treated as U.S. taxable income for foreign tax credit purposes (and for purposes of the possessions tax credit) (Code sec. 904(f)). Foreign taxable income up to the amount of the overall foreign loss may be so treated. However, unless the taxpayer elects a higher percentage, no more than 50 percent of the foreign taxable income earned in any particular year is treated as U.S. taxable income. The effect of the recapture is to reduce the foreign tax credit limitation in one or more years following an overall foreign loss year and, therefore, the amount of U.S. tax that can be offset by foreign tax credits in the later year or years.

Foreign oil and gas extraction losses incurred abroad are treated separately from other foreign losses. Foreign extraction losses first reduce other foreign extraction income. If a taxpayer's foreign extraction losses exceed its foreign extraction income, the excess ("overall foreign extraction loss") first reduces the taxpayer's other foreign taxable income, then the taxpayer's U.S. taxable income. Overall foreign extraction losses are subject to a separate loss recapture rule (sec. 907(c)(4)) that operates in substantially the same manner as the general foreign loss recapture rule. Under the overall foreign extraction loss recapture rule, a portion of foreign extraction income earned after an overall extraction loss year is treated as foreign income other than foreign extraction income for foreign tax credit purposes. If an overall foreign loss includes an overall foreign extraction loss, both recapture rules will apply in a

later year in which the taxpayer earns extraction income. The extraction income will first be recharacterized as U.S. income under the foreign loss recapture rule. Any extraction income not so recharacterized will then be subject to the overall foreign extraction loss recapture rule.

The Code does not specify whether, for foreign tax credit purposes, a loss in a separate foreign tax credit limitation "basket" first offsets foreign taxable income not subject to that particular separate limitation, or immediately offsets U.S. taxable income. Similarly, the Code is unclear regarding whether a loss in the overall limitation basket first offsets foreign taxable income subject to the separate limitations, or immediately offsets U.S. taxable income. If such losses offset U.S. taxable income first, then the overall foreign loss recapture rule presumably would have to be applied separately to overall limitation income and to each separate limitation income basket. The Code does not specifically indicate that the overall foreign loss recapture rule is to be applied in this manner. However, proposed regulations (Treas. Reg. secs. 1.904(f)-1 through -6) issued by the IRS in January 1986 take the position that the overall foreign loss recapture rule is to be applied separately to each income basket.

The committee understands that many taxpayers take the position that separate limitation and overall limitation losses immediately offset U.S. taxable income. If this position were upheld, foreign tax credits effectively could reduce U.S. tax on U.S. income. As indicated above, this result would violate a basic premise of the credit: that it should reduce the U.S. tax on foreign income only. Assume, for example, that a corporation has $100 of U.S. taxable income and $100 of foreign taxable income, the latter consisting of $200 of interest income subject to the separate limitation for interest and a $100 aggregate business loss in the income categories subject to the overall limitation. The corporation pays $80 of foreign tax on the interest income. The U.S. tax on $100 of U.S. source corporate income (assuming the bill's new maximum corporate tax rate applied) is $33. The pre-credit U.S. tax and the foreign tax credit limitation with respect to $100 of foreign source taxable income (making the same tax rate assumption) is also $33. If the corporation in this example allocates its $100 foreign business loss against its $100 of U.S. taxable income rather than against its $200 of foreign interest income, the corporation's separate limitation interest income for foreign tax credit purposes is $200 rather than $100. This allocation increases its separate foreign tax credit limitation for interest from $33 to $66. The larger limitation, in effect, lets the corporation reduce the U.S. tax on its U.S. taxable income (and its overall post-credit U.S. tax liability for the year) from $33 to zero. Under this interpretation of the law, the $33 of foregone U.S. tax might be recaptured in later years under the foreign loss recapture rule if the corporation earns overall limitation income in later years; however, the U.S. Treasury is at risk that no such income will be earned in later years or, if it is, that no U.S. tax will be due when such income is earned.

U.S. losses

Under present law, an overall U.S. loss reduces a taxpayer's foreign income, just as an overall foreign loss reduces a taxpayer's U.S. income. The U.S. loss reduces the taxpayer's U.S. tax liability and, through the application of the loss against foreign income, the foreign tax credit limitation is correspondingly reduced.

If a taxpayer earns foreign income in more than one foreign tax credit limitation "basket"–for example, income subject to the overall limitation and interest subject to the separate limitation for passive interest—any U.S. loss of the taxpayer incurred in the same year must be allocated between or among the different income baskets for foreign tax credit limitation purposes. Under a 1982 revenue ruling (Rev. Rul. 82-215, 1982-2 C.B. 153), the loss in effect is allocated first to any income basket that attracted no foreign tax, that is, an income basket that has no foreign tax credits available and, therefore, absent allocation of the loss, would bear full U.S. tax. Under an earlier revenue ruling (Rev. Rul. 81-50, 1981-1 C.B. 410), which was revoked by the one just discussed, a U.S. loss was allocated among foreign income baskets on a different basis: the loss was allocated pro rata among the income baskets.

Subpart F rules

In general, no current U.S. tax applies to the foreign income of a foreign corporation, and a U.S. investor in a foreign corporation is taxed only when income is distributed to him. However, the deferral of U.S. tax on the income of U.S.-owned foreign corporations does not apply to certain kinds of income. Under the Code's subpart F rules (Code secs. 951-64), when a U.S.-controlled foreign corporation earns tax haven income, the United States will generally tax the corporation's 10-percent U.S. shareholders currently.

Subpart F income includes foreign personal holding company income, consisting generally of several types of passive income. (The subpart F rules are discussed in greater detail at C., below in connection with changes to those rules made by the bill.)

Reasons for Change

Separate foreign tax credit limitations

The purpose of the foreign tax credit is to reduce international double taxation. Under the credit system, the United States reserves the right to collect full U.S. income tax on U.S. persons' foreign income, less any foreign income taxes imposed on that income. Under the overall foreign tax credit limitation, however, the United States sometimes collects little or no residual U.S. tax—after aggregate foreign taxes are credited—on certain types of income that are themselves taxed abroad at below the U.S. rate. This failure to collect taxes arises because the overall limitation permits a cross-crediting of taxes, generally known as "averaging." The overall limitation allows taxpayers to credit high foreign taxes paid on one stream of income against the residual U.S. tax otherwise due on other, lightly taxed foreign income.

In general, the committee believes that the overall limitation is consistent with the integrated nature of U.S. multinational oper-

ations abroad. The committee believes that the averaging of foreign tax rates generally should continue to be allowed. However, the committee recognizes that, in limited situations, averaging should not be permitted when averaging would distort the foreign tax credit limitation.

As indicated above, under current law, certain income is subject to separate foreign tax credit limitations to prevent the averaging of such income with other income. Separate foreign tax credit limitations are provided for DISC dividends, FSC dividends, taxable income of a FSC attributable to foreign trade income, and passive interest. In addition, a special limitation applies to oil and gas extraction income. DISC dividends are subject to a separate limitation because they bear no foreign tax. Similarly, FSC income is treated separately for limitation purposes because few foreign countries tax it substantially. A separate limitation applies to passive interest because U.S. taxpayers can shift the source of passive interest from the United States to foreign countries by, for example, withdrawing funds from U.S. banks and depositing them in foreign banks, and can secure a low rate of foreign tax on interest by making interest-bearing investments in foreign countries that either unilaterally, or pursuant to an income tax treaty with the United States, impose little or no tax on interest paid to a person not engaged in a trade or business in that country. Foreign taxes on oil and gas extraction income are often abnormally high: the special limitation applicable to such income prevents the cross-crediting of those high taxes against the U.S. tax on other, lightly taxed foreign income.

The committee believes that passive income in general and certain interest subject to high foreign withholding taxes—neither of which is presently subject to a separate limitation—present averaging problems similar to those presented by the types of income now subject to separate limitations. The committee recognizes that separate limitations are necessary in the case of income that frequently bears little foreign tax (for example, DISC dividends, FSC income, and passive interest) or abnormally high foreign tax (for example, oil and gas extraction income), or is relatively manipulable as to whether it has a U.S. or foreign source (for example, passive interest).

Passive income

In general, passive income earned abroad by U.S. persons (for example, portfolio stock dividends, passive rents and royalties, passive commodity trading gains, and annuities) tends to bear little or no foreign tax. Also, many forms of passive income are manipulable as to source. The incentive at the margin to place new investments abroad rather than at home, if the taxpayer has excess foreign tax credits that can be used to shelter additional foreign income from U.S. tax, is of particular concern in the case of passive investments, which often can quickly or easily be made in low or no tax foreign countries. The committee is concerned that the incentive to choose foreign over U.S. investment may grow as a result of the bill's tax rate reductions. This growth could result because lower U.S. tax rates (relative to foreign tax rates) will cause

many taxpayers to have more averagable excess credits and more taxpayers to operate in excess credit positions.

High-withholding tax interest

A number of foreign countries, particularly developing countries, impose gross withholding taxes on interest earned by nonresident lenders that significantly exceed the general income taxes that would be imposed on the associated net interest income were it taxed on a net basis. In the case of U.S. lenders, these gross withholding taxes often far exceed the pre-credit U.S. tax on the net interest income as well. When a gross withholding tax equals the pre-credit U.S. tax, the U.S. lender pays no U.S. tax on loan proceeds associated with interest subject to the withholding tax under the United States' generally applicable foreign tax credit rules. When a gross withholding tax exceeds the pre-credit U.S. tax, the U.S. lender is subject to a negative rate of U.S. tax on the foreign loan transaction (as other U.S. taxpayers operating abroad sometimes are on other foreign transactions) to the extent that the lender uses the excess foreign tax credits to reduce its U.S. tax liability on other income, derived from the same foreign country or from other sources outside the United States, that is subject to little or no foreign tax. Income from domestic loans, by contrast, generally is subject to full U.S. tax. As a result of the foreign tax credit mechanism, the U.S. Treasury, in effect, bears the burden of these high levels of foreign tax on foreign loans.

The committee is concerned, moreover, that the available evidence suggests that the economic burden of high foreign gross withholding taxes on interest falls largely, in the typical situation, on the foreign borrower rather than on the U.S. lender. To the extent that is the case, the present rules allowing a full foreign tax credit for high foreign taxes on interest paid to U.S. lenders provide an incentive for some U.S. lenders to make foreign loans rather than domestic loans that would otherwise be equally attractive, and to make otherwise uneconomical foreign loans. The higher the applicable foreign tax on interest is, the larger the U.S. lender's foreign tax available for credit is and, thus, the greater the incentive may be. The committee is particularly concerned that foreign countries seeking to attract U.S. capital may be encouraged by the present rules to increase rather than to decrease their gross withholding taxes on interest paid to U.S. persons. According to a January 1985 report in the Wall Street Journal, some U.S. bank lenders to Mexico responded negatively after the Mexican Government decided to exempt from a Mexican withholding tax on interest the interest payments made by a Mexican state-owned food distributor to foreign banks.[7] The Mexican Government subsequently withdrew the exemption.[8] The incentive for foreign countries to increase their gross withholding taxes on interest may be particularly pronounced with respect to interest paid on loans to foreign gov-

[7] S. K. Witcher, "Foreign Banks Worry Mexican Ruling Could Mean Loss of Tax Credits at Home," *Wall Street Journal*, Jan. 25, 1985, p. 24.

[8] S. Frazier & S. K. Witcher, "Debt-Swap Plan Is Proposed by Mexicans," *Wall Street Journal*, March 15, 1985, p. 29.

ernments because a foreign government generally suffers no economic detriment from a tax it imposes, in effect, on itself.

In light of these specific problems and the more general concerns expressed above, the committee believes that interest received by U.S. financial institutions and related persons that bears a foreign withholding tax (or other tax determined on a gross basis) of 5 percent or more should be subject to a separate foreign tax credit limitation. Under such a rule, high foreign gross basis taxes on interest will continue, in many or most cases, through the credit mechanism, effectively to exempt the associated net interest income from U.S. tax. However, such foreign taxes will no longer be available to reduce U.S. tax on other, low taxed foreign income of a U.S. financial institution. Applying this rule to high foreign taxes on interest is similar in some respects to the present law treatment of foreign oil and gas extraction taxes, the foreign tax credit for which is limited (in the case of U.S. companies) to the maximum pre-credit U.S. corporate tax payable on the associated extraction income.

Deemed-paid credit

Under present law, when a foreign subsidiary has profits (subject to foreign tax) in some years and deficits in other years and does not distribute all its earnings currently, a portion of the foreign tax may never be creditable. For example, although there may be no foreign tax in a year in which a deficit occurs, the foreign law may not provide for a reduction in the foreign taxes paid in earlier profitable years (that is, the foreign country may not allow a loss carryback). In such a case, even if the subsidiary pays out all its net after-tax earnings at the end of the several years, the IRS takes the position that less than all the foreign taxes paid over those years will be eligible for the credit. This is because the deficit is viewed as reducing accumulated profits for the prior years in which the foreign taxes were paid, thus reducing the total amount of creditable taxes. See Rev. Rul. 74-550, 1974-2 C.B. 209. In a branch situation in which foreign income is taxed currently, this loss of foreign credits would not occur.

Present law also affects the availability of the deemed-paid credit when a foreign corporation's effective foreign tax rate changes for any reason (for example, where foreign tax rates rise as a result of the end of a "tax holiday" or otherwise; where foreign tax rates decline; or where the effective foreign tax rates otherwise fluctuate from one year to another). It is advantageous under present law for foreign subsidiaries, where possible, to accumulate their earnings in years in which their effective foreign tax rate is low and distribute their earnings to U.S. parent corporations in years in which their effective foreign tax rate is high, rather than distributing their earnings on an annual basis with more constant dividends. Since, for purposes of computing the foreign taxes attributable to a dividend, the dividend is deemed distributed out of the subsidiary's earnings and profits for the current year first, drawing with it the foreign taxes with respect to those earnings, and then is treated as being derived from each preceding year, the distribution of dividends only in high tax years yields a higher foreign tax credit than the average foreign taxes actually paid by that foreign subsidiary over a period of years. This result would not occur in the case of a

direct branch operation, since all income would be subject to U.S. tax currently and foreign taxes eligible for the credit would be taken into account currently.

Present law thus provides opportunities for the so-called "rhythm method" of dividend distributions from foreign subsidiaries. For example, suppose a U.S. parent corporation has two foreign subsidiaries and the foreign tax rate for each can be significantly lowered in one year at the cost of an increased rate in the next year, through timing the allowance of deductions and the recognition of income. Matters can be arranged so that the high and low tax years of the subsidiaries alternate, and the U.S. parent corporation takes the dividends it needs each year from the particular subsidiary that in that year has a high foreign rate.

The committee recognizes that there are difficulties in equating the foreign tax credit results of operation through a subsidiary and a branch, principally because of the deferral that is generally available to a subsidiary. However, the committee believes that in some instances steps to provide more similar results in the two cases are desirable. The committee bill adopts an approach, on a prospective basis, that computes the deemed-paid foreign tax credit of a U.S. shareholder with reference to the post-effective date accumulated foreign taxes and pool of accumulated earnings and profits (including all earnings and profits of the current year in the pool). For administrative convenience, the post-effective date accumulated foreign taxes and pool of accumulated earnings is computed by reference to a moving 10-year pool that includes the current year, plus the nine (or fewer) immediately preceding post-effective date years.

In summary, this pooling approach is intended to have two results. It is intended to alleviate the situation in which deemed-paid foreign tax credits may be lost as a result of a deficit in a foreign corporation's earnings and profits. In addition, the committee intends to limit the ability of taxpayers to claim a deemed-paid credit that reflects foreign taxes higher than the average rate over a period of years, by averaging the high tax years and the low tax years of the foreign corporation in determining the foreign taxes attributable to the dividend.

Foreign losses

As indicated already, separate limitations function to reduce the averaging of foreign income and taxes, and the use of excess foreign tax credits, in connection with categories of foreign income that would otherwise pose particularly serious averaging problems. The committee does not believe that Congress intended separate limitations to allow taxpayers to use losses in separate limitation baskets, or in the overall limitation basket, to reduce U.S. taxable income before foreign taxable income. Congress repealed the per country limitation in 1976 specifically to prevent a net loss incurred in one foreign country from reducing U.S. taxable income before foreign taxable income earned in other foreign countries. As indicated above, using separate limitation losses to reduce U.S. taxable income before foreign taxable income inflates the foreign tax credit limitation, permitting the foreign tax credit to reduce in the loss year, and sometimes permanently, the U.S. tax on U.S.

income. The committee believes that Congress should make it clear that, for foreign tax credit limitation purposes, both separate limitation and overall limitation losses are to offset taxable income in other foreign income baskets on a pro rata basis before such losses offset U.S. taxable income.

The allocation to other foreign income of a loss in the overall limitation basket will, by reducing that other foreign income, reduce the residual U.S. tax otherwise due on that income in the event that it is lightly taxed abroad. The allocation to foreign income subject to the overall limitation of a loss in a separate limitation basket will, by reducing the overall limitation income and hence the overall limitation, result in additional excess foreign tax credits in the event that the overall limitation income bears high foreign tax. The committee believes that these effects should be mitigated. This can be accomplished in a year or years following the loss year when income is earned in the loss basket by requiring a recharacterization of that income as income of the type previously reduced by the loss.

U.S. losses

In the case of a taxpayer with income in more than one foreign income basket, the committee finds no sound policy basis for effectively allocating a U.S. loss incurred by the taxpayer in the same year first to any income basket that attracted no foreign tax and, therefore, absent the loss, would bear full U.S. tax. The committee believes that a more neutral allocation rule like that of prior law requiring that a U.S. loss be allocated pro rata among foreign income baskets should be restored. Such a rule is consistent with the pro rata allocation rule for *foreign* losses contained in the committee bill.

Subsidies

As indicated above, a Treasury regulation denies a foreign tax credit for foreign taxes used directly or indirectly as a subsidy to the taxpayer. Absent this rule, the Treasury would, in effect, bear the cost of tax subsidy programs instituted by foreign countries for the direct or indirect benefit of their residents and certain nonresidents who do business with their residents. The committee is informed that some U.S. lenders and other U.S. taxpayers take tax return positions that are inconsistent with this rule. The committee does not believe that foreign tax credits should be allowed for foreign taxes which, while ostensibly borne by a U.S. taxpayer, are effectively rebated by the levying country by means of a government subsidy to the taxpayer, a related party, a party to a transaction with the taxpayer, or a party to a related transaction. To eliminate any uncertainty in this area, the committee believes that the Treasury regulation rule disallowing foreign tax credits for taxes used as a subsidy to the taxpayer should be clarified and codified.

Explanation of Provisions

1. Overview

The bill subjects passive income to a separate foreign tax credit limitation. The bill will prevent taxpayers from using high foreign taxes paid on other income to reduce or eliminate the residual U.S. tax on passive income. Subject to several modifications and exclusions discussed below, passive income, for this purpose, generally is any income of a kind which would be foreign personal holding company income as defined for purposes of the Code's subpart F rules. The separate foreign tax credit limitation for passive income subsumes present law's separate foreign tax credit limitation for passive interest income. To prevent substantial averaging of foreign taxes and income within the passive "basket," the bill authorizes the IRS to prescribe regulations preventing manipulation of the character of income the effect of which is to avoid the purposes of the separate foreign tax credit limitations.

The bill also subjects to a separate foreign tax credit limitation interest income of U.S. financial institutions that is subject to foreign withholding tax of 5 percent or more. Under this rule, U.S. financial institutions will no longer be able to use foreign tax credits for such taxes to shelter other, lightly taxed foreign income from U.S. tax.

In general, certain payments from, and inclusions (for example, under subpart F) with respect to, related persons will be subject to the new separate limitations under look-through rules that take into account the extent to which the related persons themselves earn income of a type subject to the new separate limitations.

Under the bill, the deemed-paid credit for a U.S. corporation's share of foreign taxes paid by a foreign corporation will be determined on the basis of a 10-year pool of the foreign corporation's accumulated earnings and profits rather than, as under present law, on a year-by-year basis with the most recent year's earnings and profits taken into account first. Earnings and profits for this purpose generally will be computed in the same manner for actual distributions as they are now for tax-haven (subpart F) income inclusions. However, modified foreign currency translation rules will apply for both actual distributions and subpart F income inclusions. (These translation rules are discussed at F., below.)

The bill provides that separate limitation and overall limitation losses are to be allocated to other foreign income before U.S. income, subject to a recharacterization rule applicable in years following the loss year when income is earned in the loss basket. In addition, if, in one year, a taxpayer incurs a U.S. loss and earns income in more than one foreign income basket, the U.S. loss is to be allocated pro rata among the foreign income baskets, under the bill.

The bill also clarifies and codifies a Treasury regulation rule denying foreign tax credits for foreign taxes used directly or indirectly as subsidies to the taxpayer or certain persons connected with the taxpayer.

2. Separate foreign tax credit limitations

Passive income definition

Under the bill, passive income subject to a separate limitation generally consists of any income received or accrued by any person which is of a kind which would be subpart F foreign personal holding company income (as defined in Code sec. 954(c), as amended by the bill). Thus, passive income for separate limitation purposes generally includes dividends, interest, annuities, and certain rents and royalties. The bill expands the definition of subpart F foreign personal holding company income and modifies the subpart F definition of a related person (sec. 921 of the bill). (These changes in the anti-tax haven rules are discussed in more detail at C., below.) In general, these definitional changes apply for purposes of the separate limitation for passive income as well.

Consistent with the subpart F foreign personal holding company rules of present law, the bill excludes from passive income any rents or royalties which are derived in the active conduct of a trade or business and which are received from a person other than a related person. Rents and royalties received from certain related persons also may be excluded from passive income under look-through rules discussed in detail below.

In general, under Treas. Reg. sec. 1.954-2(d)(1), whether rents and royalties received from unrelated persons are derived in the active conduct of a trade or business is determined under a facts and circumstances test. In addition, these regulations provide safe harbor rules. It is anticipated that the standards contained in these existing regulations defining rents and royalties for purposes of excluding such rents and royalties from subpart F taxation will be followed in determining whether rents and royalties received from unrelated persons qualify for the exclusion from the separate limitation for passive income. However, the standards contained in the existing regulations will have to be modified somewhat for this purpose. For example, the committee expects that the Secretary will appropriately take into account the fact that the persons receiving the rents and royalties will sometimes be U.S. persons rather than controlled foreign corporations. In addition, the committee expects that the Secretary, in adapting the standards contained in the existing regulations, will require any determination based on facts and circumstances and any additional safe harbor rules to be consistent with the principles underlying the safe harbor rules of the existing regulations.

Excluded from passive income is interest income derived from any transaction which is related to the active conduct by the taxpayer of a trade or business in a foreign country or a U.S. possession. Dividend income derived from any such transaction is also excluded if received from a regulated investment company by a taxpayer that owns, directly or indirectly, less than 10 percent of the voting stock of the company. This exception parallels the working capital exception to the present law separate limitation for passive interest (Code sec. 904(d)(2)(A)), as that exception is modified by a technical correction to the Tax Reform Act of 1984 contained in the committee bill (sec. 1810(b)).

Following the present law subpart F definition of foreign personal holding company income, passive income does not include dividends, interest, or gains from the sale or exchange of stock or securities that are derived from the investments made by an insurance company of its unearned premiums or reserves ordinary and necessary for the proper conduct of its insurance business, and received from a person other than a related person. Also excluded from passive income are dividends, interest, and gains from the sale or exchange of stock or securities received from a person other than a related person derived from investments made by an insurance company of an amount of its assets equal to one-third of its premiums earned on insurance contracts (other than life insurance and annuity contracts) which are not directly or indirectly attributable to the insurance or reinsurance of risks of persons who are related persons.

Following the subpart F definition of foreign personal holding company income, as modified by the bill, passive income excludes dividends, interest, and gains from the sale or exchange of stock or securities derived in the conduct of a bona fide, active banking, financing, or similar business, and received from a person other than a related person. The bill's definition of a bona fide, active banking, financing, or similar business is discussed at C., below.

Consistent with the subpart F definition of foreign personal holding company income, as modified by the bill, passive income also generally includes the excess of gains over losses from the sale or exchange of any non-income producing property or property that gives rise to the following types of subpart F foreign personal holding company income: first, dividends and interest other than those excluded from subpart F under the active business exceptions for banks (as modified by the bill) and insurance companies referred to above; second, rents and royalties other than active business, unrelated party rents and royalties; and, third, annuities. Excluded from this rule are gains from the sale or exchange of property by a regular dealer in such property and gains from the sale or exchange of any other inventory property.

Also generally included in subpart F foreign personal holding company income and passive income under the bill is the excess of gains over losses from transactions (including futures transactions) in commodities other than foreign currency. However, gains from commodity transactions are not subpart F or passive income when they (1) arise out of bona fide hedging transactions reasonably necessary to the conduct of any business by a producer, processor, merchant, or handler of a commodity in the manner in which that business is customarily and usually conducted by others, or (2) are active business gains from the sale of commodities, but only if substantially all of the entity's business is that of an active producer, processor, merchant, or handler of commodities.

The excess of foreign currency gains over foreign currency losses attributable to section 988 transactions (excluding transactions directly related to the business needs of the entity) is subpart F foreign personal holding company income and passive income under the bill. For this purpose, foreign currency gains and losses attributable to section 988 transactions are defined as they are for pur-

poses of the bill's new rules relating to the taxation of foreign currency exchange rate gains and losses (sec. 961 of the bill).

As explained in more detail at C., below, the bill narrows the present law exclusion from subpart F foreign personal holding company income of certain dividends, interest, rents, and royalties received from related persons (Code sec. 954(c)(4)). The bill makes related party interest, rent, and royalty payments ineligible for the exclusion to the extent that they reduce subpart F income of the payor, and provides that the exclusion for interest paid between related banks applies only if both payor and payee are engaged in bona fide, active banking, financing, or similar operations.

The bill treats foreign personal holding company inclusions (under Code sec. 551) and passive foreign investment company inclusions (under the bill's new passive foreign investment company rules (sec. 925 of the bill)) as passive income subject to the separate limitation.

Passive income does not include any foreign oil and gas extraction income (as defined in Code sec. 907(c)) or any interest subject to the new separate limitation for high-withholding tax interest.

Interaction between passive income limitation rules and subpart F rules

Subject to "look-through" exceptions described below, the types of income treated under the bill as passive income generally will receive that separate treatment whether received by a U.S.-controlled foreign corporation, a U.S. person directly, or a related foreign person. Thus, in many cases, interest or dividend income that would have been subpart F foreign personal holding compay income if received by a U.S.-controlled foreign corporation will be passive income if received directly by a U.S. person.

However, the subpart F de minimis rule (as modified by the bill) and 70-percent full inclusion rules for foreign base company income (which includes foreign personal holding company (Code sec. 954(b)(3)) will not apply for separate limitation purposes. Thus, a controlled foreign corporation whose only foreign base company income is, for example, foreign personal holding company income constituting less than 5 percent of its gross income, will be required to treat that foreign personal holding company income as separate limitation income to the extent that it would otherwise be so treated under the passive limitation rules. Similarly, U.S. shareholders in a controlled foreign corporation who are taxed currently on all of the corporation's income because the corporation's foreign personal holding company income exceeds 70 percent of its income will be required to treat as separate limitation passive income only that portion of the income that is foreign personal holding company income without regard to the 70-percent full inclusion rule. Foreign personal holding company income received directly by U.S. persons (rather than through a controlled foreign corporation owned by them) will not be subject to the de minimis or 70-percent rule either.

Income received by a controlled foreign corporation that is excluded from subpart F foreign personal holding company income as a result of the corporation's shareholders' establishing (pursuant to

Code sec. 954(b)(4)) that the corporation was not availed of to reduce taxes is not passive income for separate limitation purposes.

Manipulation of the character of income

The bill requires the IRS to prescribe such regulations as may be necessary or appropriate to prevent manipulation of the character of income the effect of which is to avoid the purposes of the separate limitations. Absent such regulations, taxpayers may, for example, take the position that they can allocate expenses in a manner that effectively shifts, for foreign tax credit limitation purposes, high taxes paid on overall limitation income to passive income generated specifically for the purpose of such reallocation of foreign taxes. Assume, for example, that a U.S. company operates a foreign subsidiary in a high tax country. The subsidiary has $10,000 of assets and earns $1,000 of manufacturing income. Five hundred dollars of foreign tax is imposed on that income. The subsidiary repatriates all the income currently, free of any additional, foreign withholding tax. The repatriated income is subject to the overall limitation. The U.S. company also receives $300 of passive income from investments in a tax haven country. The $300 bears no foreign tax and is subject to the separate limitation for passive income.

Under the bill, the company's U.S. tax liability on its foreign income is $99: the tax is attributable entirely to the company's separate limitation passive income (33 percent of $300); the deemed-paid foreign tax credit for the $500 of tax imposed on the company's $1,000 of repatriated manufacturing income eliminates any U.S. tax liability with respect to that income. Because the $500 deemed-paid credit exceeds the $333 of U.S. tax on the manufacturing income, the company has excess foreign tax credits.

The company might take the position, however, that it can use some of the excess credits to reduce its U.S. tax liability on its passive income by entering into the following pair of transactions: the company's high tax country subsidiary borrows $8,000 at 10-percent interest and purchases an $8,000 certificate of deposit paying 10-percent interest. These transactions "wash": the company continues to earn $1,000 of manufacturing income in its high tax country subsidiary and $300 of passive investment income in the tax haven. The foreign tax on the company's $1,000 of high tax country income remains $500. However, absent the anti-abuse rule under discussion, the company might argue that allocation of its subsidiary's $800 of interest expense results in the company's having $556 of high tax country active income, bearing $278 of foreign tax, and $444 of high tax country passive income, bearing $222 of foreign tax. This result could obtain were the asset method used to allocate the subsidiary's interest expense between its $1,000 of manufacturing income and $800 of passive interest. Under the asset method, $444 of its interest expense ($10,000/$18,000 x $800) would be allocated to its $1,000 of manufacturing income and $356 ($8,000/$18,000 x $800) would be allocated to the subsidiary's $800 of interest income. If $444 of the subsidiary's $1,000 of earnings were in fact treated as high tax country passive income bearing $222 of the foreign tax, then the company's U.S. tax liability would be reduced to $23.52: pre-deemed-paid credit tax (at a 33-percent rate) of

$245.52 on the company's $744 ($300 + $444) of passive income, less a $222 deemed-paid credit for the foreign tax allocated to the passive interest. The $556 still characterized as active income would continue to be free of U.S. tax because of the deemed-paid credit assigned it.

The committee intends that the regulations prevent manipulation of the character of income such as that illustrated in the above example and, in addition, other manipulations of income character that have little economic significance in relation to the reduction of post-foreign tax credit U.S. tax liability. For example, the committee expects that in the above example the regulations would provide that the borrowing and lending pair of transactions be ignored for foreign tax credit limitation purposes.

High-withholding tax interest

Under the bill, a separate foreign tax credit limitation applies to high-withholding tax interest. High-withholding tax interest generally is any interest received or accrued by a bank or other financial institution or an insurance company, if such interest is subject to a foreign withholding tax (or other tax determined on a gross basis) of 5 percent or more. High-withholding tax interest also generally includes any interest subject to such a tax that is received or accrued by a person related to a bank or other financial institution or an insurance company (unless the interest is directly related to the active conduct by the related person of a trade or business). High-withholding tax interest does not include any interest derived by a finance company in connection with export financing of products manufactured by a related person.

For purposes of the new rule, a related person is any individual, corporation, partnership, trust, or estate which has 50-percent control of, or is 50-percent controlled by, the taxpayer, and any corporation, partnership, trust, or estate which is 50-percent controlled by the same person or persons which have 50-percent control of the taxpayer.

The new separate limitation applies to all foreign gross-basis taxes imposed on interest income received or accrued by the entities described above. The committee intends that, under regulations, other taxes on interest that are substantially similar in the sense that their imposition results in heavier taxation by the levying country of foreign financial institutions than residents also be subjected to the new rule.

The bill authorizes the IRS to provide by regulation that any amount equivalent to interest will be treated as interest for purposes of the separate limitation for high-withholding tax interest.

Look-through rules

Dividends, interest, rents, and royalties from, and subpart F inclusions with respect to, certain related persons will be subject to the separate limitation for passive income, the separate limitation for high-withholding tax interest, or the overall limitation in accordance with look-through rules that take into account the income of the payor itself. A dividend received by a 10-percent shareholder of the payor, for example, will not automatically be treated as 100-percent passive income because it is income of a kind which would

be subpart F foreign personal holding company income. Subpart F inclusions are subject to a look-through rule, too. The look-through rules are intended to reduce disparities that might otherwise occur between the amount of income subject to a particular limitation when a taxpayer earns income abroad directly (or through a foreign branch), and the amount of income subject to a particular limitation when a taxpayer earns income abroad through a controlled foreign corporation or other related person.

The committee bill subjects interest, rents, and royalties to look-through rules because such payments often serve as alternatives to dividends as a means of removing earnings from a controlled foreign corporation or other related person. In addition, the committee believes that such interest, rents, and royalties should be treated for separate limitation purposes like dividends eligible for a deemed-paid foreign tax credit[9] so that payment of the former will not be discouraged. Interest, rents, and royalties generally are deductible in computing tax liability under foreign countries' tax laws while dividends payments generally are not; thus, in the aggregate, interest, rent, and royalty payments reduce foreign taxes of U.S.-owned foreign corporations more than dividend payments do. Under the foreign tax credit system, the payment of interest, rents, and royalties by controlled foreign corporations and other related foreign corporations whose dividends carry a deemed-paid credit may, therefore, reserve for the United States more of the pre-credit U.S. tax on these U.S.-owned corporations' foreign earnings than the payment of dividends.

In general, for purposes of all the look-through rules, a related person is any foreign corporation in which the taxpayer owns directly or indirectly at least 10 percent of the voting stock. For purposes of the look-through rule applicable to dividends, interests, rents, and royalties received from a related person that has passive income, a related person is defined more broadly than it is for purposes of the other look-through rules. Under the look-through rules, a dividend includes any gain treated as ordinary income under section 1246 or as a dividend under section 1248.

The look-through rules for dividends, interest, rents, and royalties replace the related party interest exception (existing Code sec. 904(d)(1)(C)) to the present law separate limitation for interest. The bill also supplants the rules enacted in 1984 to maintain the separate limitation character of interest income (existing Code sec. 904(d)(3)).

Subpart F inclusions generally

The bill generally treats subpart F inclusions (Code sec. 951(a)) with respect to income of a controlled foreign corporation as income subject to the overall limitation, income subject to the separate limitation for passive income, or income subject to the separate limitation for high-withholding tax interest (as the case may be) to the extent attributable to income of the controlled foreign corporation subject to each of these limitations. Under Code section 951(d) (amended as part of the Tax Reform Act of 1984), an amount

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[9] Absent an applicable look-through rule, interest, dividends, and passive rents and royalties are generally fully subject to the separate limitation for passive income.

that would otherwise constitute both a subpart F inclusion and a foreign personal holding company inclusion (under Code sec. 551(a)) is treated as a subpart F inclusion. An amount that would otherwise constitute both a subpart F inclusion and a passive foreign investment company inclusion (under sec. 925 of the bill) also is to be treated as a subpart F inclusion for these purposes.

The general look-through rule for subpart F inclusions may be illustrated as follows: Assume that a controlled foreign corporation wholly owned by a U.S. corporation earns $100 of net income. Ninety-five dollars of the income is foreign base company sales income and $5 is passive royalty income that is foreign personal holding company income for subpart F purposes. No foreign tax is imposed on the income. All of the income is subpart F income taxed currently to the U.S. parent corporation. Since $95 of the $100 subpart F inclusion is attributable to income of the foreign corporation subject to the overall limitation, $95 of the subpart F inclusion is treated as overall limitation income of the parent corporation. Since $5 of the subpart F inclusion is attributable to income of the foreign corporation subject to the separate limitation for passive income, $5 of the subpart F inclusion is treated as separate limitation passive income of the parent corporation.

Subpart F inclusions attributable to investments of earnings in U.S. property (sec. 951(a)(1)(B)) are subject to a different look-through rule: that applicable to dividends, interest, rents, and royalties received from a related person that has passive income (see below). This is because such subpart F inclusions, unlike subpart F inclusions of foreign personal holding company income, cannot be identified with specific income received by a controlled foreign corporation.

Dividends, interest, rents, and royalties from related persons with passive income

The bill treats dividends, interest, rents, and royalties that are paid or accrued by a "designated payor corporation" as passive income subject to the separate limitation for passive income to the extent that the aggregate amount of such dividends, interest, rents, and royalties does not exceed the "separate limitation passive income" of the designated payor corporation. Subpart F inclusions attributable to investments of a designated payor corporation's earnings in U.S. property (secs. 951(a)(1)(B) and 956) are also subject to this look-through rule.

The bill treats amounts paid by a designated payor corporation (and subpart F inclusions attributable to investments of its earnings in U.S. property) as first attributable to passive income under the theory that it would generally be as easy for the ultimate passive income recipient to have received the passive income directly as to have channeled it through a designated payor corporation. In addition, this "stacking" of passive income prevents avoidance of tax through the use of back to back loans.

The bill defines the term "designated payor corporation" to mean any of the following entities if the taxpayer owns directly or indirectly at least 10 percent of the entity's voting stock: (1) a foreign corporation; (2) a domestic corporation that earns less than 20 percent of its gross income from U.S. sources over a 3-year period

(an "80/20 company") (existing Code secs. 861(a)(1)(B) and 861(a)(2)(A)); or (3), under regulations, a foreign entity other than a corporation.

The bill defines the term "separate limitation passive income" to mean the aggregate amount of the passive income subject to the separate limitation for passive income which is received or accrued by the designated payor corporation, reduced by any foreign personal holding company inclusion (under sec. 551), subpart F foreign personal holding company inclusion (under sec. 951(a)(1)(A)), or passive foreign investment company inclusion (under new Code sec. 1246A) with respect to such passive income, and reduced by any income previously treated as passive by operation of this look-through rule. The bill provides that income received or accrued by a designated payor corporation from another member of the same affiliated group (determined under section 1504 but without regard to whether the related person is a foreign person) is treated as separate limitation passive income if and only if that income is attributable (directly or indirectly) to separate limitation passive income of any other member of that affiliated group.

Interest, rents, and royalties that a designated payor corporation pays or accrues to any person who owns directly or indirectly 10 percent or more of its voting stock do not reduce separate limitation passive income of the designated payor corporation, for the purpose of determining the amount of the designated payor corporation's separate limitation passive income that is available to characterize payments of, and inclusions with respect to, that corporation.

The order in which the bill treats amounts attributable to separate limitation passive income as income subject to the separate limitation for passive income is as follows: first, interest; second, rents; third, royalties; fourth, dividends; and, fifth, subpart F inclusions attributable to investments of earnings in U.S. property. This look-through rule will operate on the basis of a 10-year, post-effective date pool of separate limitation passive income, consistent with the 10-year pooling rule provided by the bill for computing the deemed-paid credit. A 10-year pooling approach ensures that dividends paid from prior year passive earnings and profits under the bill's deemed-paid credit rules will be treated as passive.

The following example illustrates the operation of this look-through rule and its interaction with the general look-through rule for subpart F inclusions previously discussed: In 1987, a controlled foreign corporation wholly owned by a U.S. company earns $200 of gross manufacturing income and $5 of gross passive rents. The $5 of gross rents is reduced by $1 of expenses. The $4 of net passive rents is income of a type that is foreign personal holding company income for subpart F purposes and, therefore, is separate limitation passive income. However, no subpart F inclusion is required with respect to this income because the subpart F de minimis rule (as modified by the bill) applies. The foreign corporation pays no dividends, interest, rents, or royalties and invests none of its earnings in U.S. property in 1987.

In 1988, the foreign corporation earns $150 of gross manufacturing income and $30 of gross passive rents. Its expenses include $6 of royalties and $6 of interest, both paid to its U.S. parent. The $30

of gross rents is reduced by $7 of expenses, including $1 of the royalties and $1 of the interest just mentioned. The foreign corporation pays no rents or dividends and invests none of its earnings in U.S. property in 1988. Its $23 of net passive rents is foreign personal holding company income for subpart F purposes and passive income for separate limitation purposes. Because the $23 subpart F inclusion to its U.S. parent is attributable entirely to income subject to the separate limitation for passive income, under the general subpart F look-through rule discussed above the full $23 inclusion is treated as separate limitation passive income of the parent corporation.

To determine whether any portion of the interest and royalty payments made by the foreign corporation to its parent will be treated as passive income to the parent, the amount of the foreign corporation's "separate limitation passive income" must be computed: First, applying the 10-year pooling rule, separate limitation passive income includes the $4 of net passive rents received by the foreign corporation in 1987. Second, separate limitation passive income initially includes the $23 of passive rents received in 1988. However, the full $23 is subsequently deducted from separate limitation passive income because it has already been treated as passive income of the parent under the general subpart F look-through rule. Third, separate limitation passive income includes $1 of the $6 royalty payment and $1 of the $6 interest payment because $1 of each payment reduced the foreign corporation's $30 of gross passive rental income. Thus, in 1988, the amount of separate limitation passive income for purposes of applying the look-through rule is $6 ($4 + $23 - $23 + $1 + $1).

Under the ordering rules, interest is treated as passive income before royalties. Thus, the full $6 interest payment to the foreign corporation's parent is treated as passive income of the parent. (When a look-through rule applies, the working capital exception applies at the related person level, not at the U.S. taxpayer level.) Since this characterization reduces the available pool of separate limitation passive income to zero, the full $6 royalty payment to the foreign corporation's parent is treated as overall limitation income of the parent.

Dividends, interest, rents, and royalties from related persons with high-withholding tax interest

Separate look-through rules are provided for dividends, interest, rents, and royalties received from related persons with high-withholding tax interest. If a related payor has both separate limitation passive income and other income, including high-withholding tax interest, the look-through rule for payments from related persons with passive income applies first. That is, dividends, interest, rents, and royalties received from such persons first will be treated as passive income to the extent of the payor's present and prior year separate limitation passive income that has not yet been used to characterize payments made by (and inclusions with respect to) the payor. Only when the payor's pool of separate limitation passive income is exhausted will its dividends, interest, rents, and royalties be subject to characterization as high-withholding tax interest under the look-through rule described below.

The bill treats interest, rents, and royalties received or accrued from any foreign corporation in which the taxpayer owns directly or indirectly at least 10 percent of the voting stock as income subject to the overall limitation or income subject to the separate limitation for high-withholding tax interest (as the case may be) to the extent properly allocable (under regulations prescribed by the Secretary) to income of the payor subject to each of these limitations. Under this rule, for example, interest paid to a parent financial institution by a subsidiary that itself earns only high-withholding tax interest is treated as high-withholding tax interest. The committee intends that interest, rents, and royalties be allocated for purposes of this rule using the same method used to compute the amount of any subpart F inclusion made with respect to the payor (see, for example, Code sec. 954(b)(5)).

The look-through rule for interest, rents, and royalties from related persons with high-withholding tax interest may be illustrated as follows: Asume that a foreign bank wholly owned by a U.S. financial institution earns $85 of gross interest income from bona fide, active banking loans made to unrelated persons. Twenty-five dollars of the interest is high-withholding tax interest. The remainder is income of a type subject to the overall limitation. The foreign bank incurs total expenses of $115, consisting of $70 of interest paid on unrelated party deposits, $30 of interest paid to its U.S. parent, and $15 of rent paid to an unrelated party. Thus, the foreign bank incurs a net loss of $30 for the year. The foreign bank owns $500 of assets, consisting of high-withholding tax loans of $145 and other unrelated party loans of $355. To determine how much of the $30 of interest payments to the U.S. parent is treated as separate limitation high-withholding tax interest of the U.S. parent, the payments must be allocated to gross high-withholding tax interest and other gross income of the foreign bank. The asset method is used to allocate interest under the provision. Thus, $8.70 of the interest paid ($30 x $145/$500)) is allocated against the foreign bank's $25 of gross high-withholding tax interest and $21.30 ($30 x ($355/$500)) against the foreign bank's $60 of other income. Therefore, $8.70 of the $30 of interest paid by the foreign bank to its U.S. parent is treated as separate limitation high-withholding tax interest of the U.S. parent.

The bill treats a portion of any dividend received from a foreign corporation in which the taxpayer owns directly or indirectly at least 10 percent of the voting stock as overall limitation income or separate limitation high-withholding tax interest (as the case may be) on the basis of a separate limitation income ratio. Subpart F inclusions attributable to investments by such a foreign corporation of its earnings in U.S. property are subject to the same rule. For each of these foreign tax credit limitation categories, the separate limitation income ratio of a dividend equals the separate limitation earnings and profits out of which the dividend was paid divided by the total earnings and profits (reduced by those attributable to passive income) out of which the dividend was paid. Under section 904 of the bill (discussed in detail below), dividends are considered to be paid from a 10-year pool of the distributing corporation's accumulated profits (in the case of actual distributions) rather than, as under present law, from the most recently accumu-

lated profits of the distributing corporation. The committee intends that taxpayers use the same expense allocation method for determining separate limitation earnings and profits under this look-through rule, and for determining the portion of interest, rents, and royalties allocable to separate limitation high-withholding tax interest (and, therefore, treated as such interest) under the look-through rule for such payments previously discussed.

The look-through rule for dividends will operate as follows: Assume, for example, that a foreign bank wholly owned by a U.S. financial institution has no income in the current year. It pays a $200 dividend in the current year out of a 3-year post-enactment pool of earnings and profits. Earnings and profits for the earlier taxable years included in the 3-year pool were $1,000 and were not subpart F income. Two-hundred dollars of those earnings were attributable to high-withholding tax interest. In the case of the separate limitation for high-withholding tax interest, the separate limitation income ratio with respect to the $200 dividend equals one-fifth ($200/$1,000). Therefore, one-fifth of the dividend, $40, is treated as separate limitation high-withholding tax interest of the payor's U.S. parent.

As another example, assume that a foreign bank wholly owned by a U.S. financial institution has a 3-year post-enactment pool of earnings and profits of $990, none of which has been previously taxed by the United States. Three hundred and thirty dollars of earnings and profits were earned in each of the 3 pool years. In the first year, $30 of the $330 total was high-withholding tax interest. In the second year, $20 of the $330 total was high-withholding tax interest. The foreign bank pays a dividend of $200 out of the $990 of earnings and profits. For the separate limitation for high-withholding tax interest, the separate limitation income ratio with respect to the $200 dividend equals 5/99ths ($50/$990). Therefore, 5/99ths of the $200 dividend, $10.10, is treated as separate limitation high-withholding tax interest of the U.S. parent.

Other rules relating to new separate limitations

The bill requires the Secretary to prescribe such regulations as may be necessary or appropriate for purposes of the separate limitation rules, including regulations for the application of the look-through rules in the case of income paid through one or more entities or between two or more chains of entities. For example, a first tier controlled foreign corporation may receive interest or royalties from a second tier controlled foreign corporation. Such amounts will be characterized as separate limitation passive income or separate limitation high-withholding tax interest of the first tier controlled foreign corporation by applying the look-through rules for interest, rents, and royalties described above to the second tier controlled foreign corporation's income.

The bill clarifies that the deemed-paid credit limitation rules (sec. 902) and the subpart F deemed-paid credit limitation rules (sec. 960), as well as the general foreign tax credit limitation rules (secs. 904(a)-(c)), apply separately to categories of income subject to separate limitations. The committee anticipates that regulations will prescribe rules for determining the amount of foreign taxes considered paid for separate limitation purposes with respect to

particular separate limitation passive income or high-withholding tax interest. To insure that the new separate limitations limit averaging as intended, the regulations will provide appropriate rules prohibiting the allocation to income subject to a particular separate limitation of foreign taxes that can be traced to other income. The committee anticipates that the regulations will be patterned generally after existing regulations that set forth rules for determining the amount of foreign taxes considered paid with respect to separate limitation passive interest (Treas. Reg. sec. 1.904-4(d)(2)) and foreign oil related income and foreign oil and gas extraction income (Treas. Reg. sec. 1.907(c)-(3)). The committee intends that foreign taxes paid on U.S. income be creditable only against the U.S. tax on overall limitation income.

Under the bill, foreign tax credit carryovers allowed for foreign taxes paid in pre-effective date taxable years reduce the U.S. tax in post-effective date taxable years on income of the same limitation type as the income on which the carryover taxes were imposed. For example, foreign tax credit carryovers to a post-effective date taxable year that are allowed for foreign taxes paid in pre-effective date taxable years on portfolio dividends then subject to the overall limitation are only to reduce the U.S. tax on overall limitation income (as defined after the effective date). Similarly, carryovers from the present law basket for interest are to reduce U.S. tax on post-effective date passive income. Under the bill, post-effective date carrybacks from any basket to pre-effective date taxable years may reduce the U.S. tax on overall limitation income only. The amount of any post-effective date carryback is limited to the amount of such carryback that would have arisen, other things equal, if the tax rates in effect in the year to which the tax is carried back were the tax rates applicable in the year in which the carryback arises. This rule is necessary to prevent taxpayers from effectively obtaining the benefit of the bill's rate reductions for earlier years in which tax rates were higher.

3. Deemed-paid credit

For purposes of computing the deemed-paid foreign tax credit, dividends or subpart F inclusions will be considered made from a moving 10-year pool of the distributing corporation's accumulated earnings and profits. Accumulated earnings and profits for this purpose will include the earnings and profits of the current year undiminished by the current distribution or subpart F inclusion. The rule treating actual distributions made in the first 60 days of a taxable year as made from the prior year's accumulated profits is repealed. A dividend or subpart F inclusion is considered to bring with it a pro rata share of the accumulated foreign taxes paid by the subsidiary on or with respect to the accumulated earnings in the 10-year moving pool.

Earnings and profits computations for these purposes will be made under rules similar to those now required for subpart F deemed dividends (and permitted for actual distributions). However, the rules for translating foreign currency are modified. (See F., below.)

Pooling will apply prospectively only. Future dividends will be treated as paid first out of the pool of all accumulated profits de-

rived by the payor after the effective date during the current year and the immediately preceding 9-year period (or shorter period if there are not 9 preceding post-effective date years). Dividends in excess of that accumulated pool of post-effective date earnings and profits will be treated as paid out of the next most recent 10-year (or shorter if there are not 10 remaining post-effective date years) pool of post-effective date accumulated profits. Dividends in excess of all post-effective date accumulated profits will be treated as paid out of pre-effective date accumulated profits under the ordering principles of present law.

If a dividend is paid from a lower-tier to an upper-tier foreign subsidiary, it is intended that the provisions of present law will apply to determine the year in which the dividend is included in earnings and profits of the recipient. For example, a post-effective date dividend from a second-tier foreign subsidiary to a first-tier foreign subsidiary will be treated as increasing the earnings and profits of the recipient in the year of the dividend. The recipient's deemed-paid taxes will be computed on the basis of the payor's most recent post-effective date 10-year (or shorter) moving pool of accumulated earnings and of foreign taxes.

In the case of a foreign corporation that does not have a 10-percent (direct or indirect) U.S. shareholder who qualifies for the deemed-paid credit, as of the first taxable year the bill is generally effective, pooling will begin with the first day of the first taxable year thereafter in which there is such a 10-percent shareholder.

There is no change in the present law provision that a subpart F inclusion from a lower-tier foreign subsidiary is included directly in the U.S. shareholder's income without passing through any upper tier foreign corporation.

The pooling provisions of the bill apply only for purposes of determining the deemed-paid foreign tax credit. For example, they do not change the present law provisions limiting to current earnings and profits the amount that can be treated as a current subpart F inclusion to the controlled foreign corporation's shareholders. However, the deemed-paid credit with respect to such an inclusion is determined by reference to the controlled foreign corporation's 10-year (or shorter) pool of accumulated earnings and of taxes, in order to limit opportunities to avoid the effect of pooling by creating subpart F inclusions.

Similarly, the pooling provisions do not change the computation of earnings and profits and the treatment of deficits for purposes of determining the amount of a subpart F inclusion or a dividend. For example, if in 1987 a foreign subsidiary wholly owned by a U.S. parent is established and incurs a $100 deficit and in 1988 the subsidiary has $50 of earnings and profits attributable to subpart F income, the parent will have no subpart F inclusion for 1988 due to the accumulated deficit (sec. 952(c)). On the other hand, if the subsidiary made a $50 distribution to its U.S. parent in 1988, the U.S. parent would have a $50 dividend in 1988 due to the presence of $50 of earnings and profits for that year (sec. 316(a)(2)). However, because of the accumulated deficit in the 2-year pool of post-effective date earnings, no deemed-paid credit would be available with respect to the 1988 dividend.

The Secretary is authorized to prescribe rules to implement these provisions. As discussed above, the committee anticipates that regulations will prescribe rules for determining the amount of foreign taxes considered paid for separate limitation purposes with respect to separate limitation income. To implement the intent that the deemed-paid credit limitation rules apply separately to categories of income subject to separate limitations, separate pools of earnings and profits and of foreign taxes must be maintained for the types of income subject to separate limitations. Thus, for example, as discussed above, once it has been determined that there are sufficient accumulated earnings and profits to cause a subpart F inclusion, the subpart F inclusion itself (if not attributable to investment in U.S. property) will be characterized on a pro-rata basis in accordance with the separate limitation or overall limitation character of the income to which it is attributable. The subpart F deemed-paid credit, with respect to any separate limitation passive income or other separate limitation income, is then determined by reference to the 10-year (or shorter) pool of the applicable separate limitation accumulated profits and related taxes, and the deemed-paid credit with respect to any overall limitation income is determined by reference to the 10-year (or shorter) pool of overall limitation accumulated profits and related taxes. In the case of a subpart F inclusion attributable to investments of earnings in U.S. property (under section 956), or in the case of a dividend, the separate limitation character of the inclusion or dividend is determined under somewhat different look-through rules. (See discussion of separate limitations and related look-through rules above.) Once that determination has been made, again, the deemed-paid credit with respect to separate limitation or overall limitation income is determined by reference to the pools of accumulated profits and taxes attributable to that limitation category of income. The principles of the foreign loss rules and related recharacterization provisions discussed below will also be applied in determining the separate limitation and overall limitation accumulated profits of foreign corporations for these purposes.

4. Foreign losses

The bill provides that, for foreign tax credit limitation purposes, losses for any taxable year in separate foreign tax credit limitation "baskets" and in the overall limitation basket offset U.S. source income only to the extent that the aggregate amount of such losses exceeds the aggregate amount of foreign income earned in other baskets. These losses (to the extent that they do not exceed foreign income for the year) are to be allocated on a proportionate basis among (and operate to reduce) the foreign income baskets in which the entity earns income in the loss year. Losses in all separate limitation baskets (enumerated in Code sec. 904(d)(1), as amended by the bill), including the passive and high-withholding tax interest income baskets, are subject to this rule.

A separate limitation loss recharacterization rule applies to foreign losses allocated to foreign income pursuant to the above rule. The recharacterization rule is similar to the overall foreign extraction loss recapture rule of present law (Code sec. 907(c)(4)). If a separate limitation loss or an overall limitation loss was allocated to income subject to another separate limitation (or, in the case of a

separate limitation loss, to overall limitation income) and the loss basket has income for a subsequent taxable year, then that income (to the extent that it does not exceed the aggregate separate limitation losses in the loss basket not previously recharacterized under this provision) is to be recharacterized as income previously offset by the loss in proportion to the prior loss allocation not previously taken into account under this provision.

To the extent that that prior loss allocation, by reducing (for limitation purposes) foreign income that was subject to high foreign taxes, gave rise to additional excess foreign tax credits, the subsequent treatment of additional income as if it were such high tax foreign income will increase the foreign tax credit limitation in the year or years when the recharacterization occurs. To the extent that the loss allocation, by reducing (for limitation purposes) income that bore little or no foreign tax, reduced post-foreign tax credit U.S. tax liability in the loss year, the subsequent treatment of additional income as income of the type that bore little foreign tax will result in a recovery of some or all of the previously foregone U.S. tax revenue in the year or years when the recharacterization occurs.

The following is an example of how the bill's foreign loss allocation and separate limitation loss recharacterization provisions will operate: Assume a U.S. corporation earns $200 of U.S. income, $20 of foreign income subject to the separate limitation for passive income, and $5 of foreign income subject to the separate limitation for certain distributions from a FSC in a taxable year. The corporation also incurs a $10 overall limitation loss in that taxable year. Under the bill's foreign loss allocation rule, the $10 overall limitation loss is allocated on a proportionate basis among the foreign income baskets in which the corporation earns income in the loss year. Thus, $8 of that loss is allocated to its $20 of passive income and the remaining $2 of the loss is allocated to its $5 of FSC distributions. None of the loss is allocated to its $200 of U.S. income. Thus, for foreign tax credit limitation purposes, the corporation has $12 of passive basket income, $3 of income in the FSC distribution basket, and $200 of U.S. income for the taxable year.

In the following taxable year, the corporation earns $25 of passive basket income, $5 of income in the FSC distribution basket, and $50 of overall limitation income. Because the corporation had a $10 overall limitation loss in the previous year that was allocated to separate limitation income in that year, $10 of its $50 of overall limitation income is recharacterized under the bill's separate limitation loss recharacterization rule as income of the type previously offset by that loss. That recharacterization is in proportion to the prior loss allocation. Thus, $8 of the overall limitation income is recharacterized as passive basket income and $2 of the overall limitation income is recharacterized as income in the FSC distributions basket. Thus, for foreign tax credit limitation purposes, the corporation has $33 of passive basket income, $7 of income in the FSC distributions basket, and $40 of overall limitation income in the second taxable year.

The bill's foreign loss allocation and separate limitation loss recharacterization rules apply to foreign persons to which the bill's separate limitation look-through rules apply, as well as to U.S. per-

sons. The bill requires the IRS to prescribe such regulations as may be necessary or appropriate for purposes of the separate limitations, including regulations for the application of the foreign loss allocation and separate limitation loss recharacterization rules in the case of income paid through one or more entities or between two or more chains of entities.

Foreign taxes on income recharacterized under the separate limitation loss recharacterization rule are not themselves to be recharacterized. For example, foreign taxes on overall limitation income that is recharacterized as separate limitation income in a year following an overall limitation loss year may only be credited against U.S. tax on other overall limitation income.

For purposes of the bill's foreign loss allocation and separate limitation loss recharacterization provisions, the amount of a loss in a separate limitation basket or in the overall limitation basket is determined under the principles of the present law provision that defines foreign oil and gas extraction losses for purposes of the overall foreign extraction loss recapture rule (Code sec. 907(c)(4)(B)). Thus, a loss in the separate limitation basket or the overall limitation basket is the amount by which the taxpayer's (or in the case of an affiliated group filing a consolidated return, the group's) gross income from activities giving rise to income in that basket is exceeded by the sum of the expenses, losses, and other deductions properly apportioned or allocated to that income and a ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income (under Code sec. 862(b) or 863).

If no foreign loss has been sustained in the case of an affiliated group of corporations filing a consolidated return, then no such loss is subject to recharacterization under this provision even if a member of the group had such a loss and the member is subsequently sold or otherwise leaves the group. In computing the amount of a foreign loss for purposes of the bill's foreign loss allocation and separate limitation loss recharacterization provisions, the net operating loss deduction (under Code sec. 172(a)) is not to be taken into account. For purposes of these provisions, a taxpayer is to be treated as sustaining a foreign loss whether or not the taxpayer claims a foreign tax credit for the year of the loss.

In cases where a taxpayer realizes an overall foreign loss, both the overall foreign loss recapture rule of present law (Code sec. 904(f)) and the separate limitation loss recharacterization rule will apply. For example, if a U.S. corporation has a loss in the overall limitation basket of $100, $75 of separate limitation foreign income, and $100 of U.S. income, the $100 loss first offsets the $75 of separate limitation foreign income (under the bill's foreign loss allocation rule) and then offsets $25 of U.S. income. If, in a subsequent year, the corporation has $100 of overall limitation income, the prior year's $100 loss will first recharacterize $25 of that income as U.S. income under the overall foreign loss recapture rule and will then recharacterize the remaining $75 of that income as separate limitation income under the separate limitation loss recharacterization rule.

5. U.S. losses

The bill provides that any U.S. loss for any taxable year is allocated among (and operates to reduce) foreign income in different limitation baskets on a proportionate basis. Assume, for example, that a U.S. corporation has a $100 U.S. loss, $150 of net overall limitation income, and $50 of net passive income in a taxable year. Under the bill, $75 of the loss reduces overall limitation income and $25 of the loss reduces passive income. For foreign tax credit limitation purposes then, the corporation has $75 of overall limitation income and $25 of passive income for the taxable year.

This rule applies after any foreign losses have been allocated among the foreign income baskets in which the taxpayer earns income.

6. Subsidies

The bill also contains a provision intended to clarify and codify a rule embodied in Treas. Reg. sec. 1.901-2(e)(3). That regulation generally provides that any foreign government subsidies accorded in connection with foreign taxes reduce the creditable portion of such taxes. Under the bill, any income, war profits, or excess profits tax is not treated as a creditable tax to the extent that the amount of the tax is used, directly or indirectly, by the country imposing the tax to provide a subsidy by any means (such as through a refund or credit) to the taxpayer, a related person (within the meaning of Code sec. 482), any party to the transaction, or any party to a related transaction, and the subsidy is determined, directly or indirectly, by reference to the amount of the tax, or the base used to compute the tax.

Assume, for example, that a U.S. bank lends money to a foreign development bank. The foreign development bank relends the money to companies resident in the foreign bank's residence country. The foreign bank's residence country imposes a withholding tax on the interest that the foreign development bank pays to the U.S. bank. On the date that the tax is withheld by the foreign bank, 50 percent of the tax is credited by the levying country to an account of the foreign development bank. The levying country requires the foreign development bank to transfer the amount credited to the borrowing companies. Since the amount transferred by the levying country to the borrowing companies (through the foreign bank) is determined by reference to the amount of the tax and is a subsidy to parties to transactions that are related to the taxable transaction, the amount transferred is not treated as a creditable tax under the bill.

The committee is aware that the validity under current law of a ruling predating Treas. Reg. sec. 1.901-2(e)(3) that embodies its substance is being challenged in litigation pending in the U.S. Tax Court. No inference should be drawn from the committee's action as to the validity or invalidity of the regulation or ruling for years prior to the effective date of the bill.

Effective Dates

In general, the bill's foreign tax credit provisions apply to taxable years beginning after December 31, 1986. However, in the case

of the new separate limitation for high-withholding tax interest, a transitional rule is provided.

Under this transitional rule, the separate limitation for high-withholding tax interest generally will not apply to interest accrued in taxable years before 1997 on loans held by the taxpayer on November 16, 1985. In addition, subject to certain limitations described below, the separate limitation for high-withholding tax interest will not apply to interest received or accrued by a taxpayer (without time limit) on a "qualified loan" outstanding on or before the last day of the taxpayer's first taxable year beginning after 1988 (for example, December 31, 1989 for a calendar year taxpayer). A qualified loan generally is any loan made by the taxpayer to any of the following 15 countries or any resident of any such country for use in such country: Argentina, Bolivia, Brazil, Chile, Columbia, Ecuador, the Ivory Coast, Mexico, Morocco, Nigeria, Peru, the Philippines, Uruguay, Venezuela, and Yugoslavia. During a three-year transitional period ending with the last day of a taxpayer's first taxable year beginning after 1988, the credit-based limitation described below will, in certain circumstances, reclassify qualified loans as non-qualified loans.

The separate limitation for high-withholding tax interest applies to interest received or accrued on qualified loans held by a taxpayer for taxable years beginning after 1986 only to the extent the total amount of foreign taxes which would be creditable (without regard to the foreign tax credit limitation) with respect to such loans for such taxable year exceeds the "applicable credit limit" for such taxable year. For purposes of applying this limitation, if the foreign taxes creditable for taxable year beginning before 1990 with respect to any qualified loan, when added to the aggregate amount of foreign taxes creditable for that taxable year with respect to qualified loans entered into by the taxpayer before the date on which the qualified loan in question was entered into, exceed the applicable credit limit, then the portion of that qualified loan that causes the taxpayer to exceed the applicable credit limit will be classified as a non-qualified loan for the taxable year. That portion of a qualified loan that would cause a taxpayer to exceed the applicable credit limit for post-1989 qualified loans as of the last day of the first taxable year beginning after 1988 will be classified as a non-qualified loan for all subsequent taxable years. For this purpose, a taxpayer will apply a method similar to that used to calculate the base credit amount (explained below) to determine the amount of taxes otherwise creditable with respect to loans outstanding on the last day of the first taxable year beginning after 1988. Qualified loans held by a taxpayer will be classified as non-qualified loans pursuant to a last in first out method, beginning with the qualified loan most recently entered into by the taxpayer. Beginning in 1990, all loans will have been classified as post-1989 qualified loans or non-qualified loans; all loans then classified as post-1989 qualified loans will be permanently grandfathered.

The "applicable credit limit" for taxable years beginning after 1986 equals: for the first taxable year beginning after 1986, the "base credit amount" increased by 3 percent and multiplied by the "applicable interest rate adjustment" for such taxable year; for the first taxable year beginning after 1987, the amount just calculated

(without regard to the interest rate adjustment) increased by 3 percent and multiplied by the applicable interest rate adjustment for such taxable year; and for the first taxable year beginning after 1988, the amount just calculated (without regard to the interest rate adjustment) increased by 3 percent and multiplied by the applicable interest rate adjustment for such taxable year. In the case of post-1989 qualified loans, the applicable credit limit is the amount just calculated (without regard to the interest rate adjustment) multiplied by the interest rate adjustment for post-1989 qualified loans.

With respect to a given taxpayer, the "base credit amount" equals the principal amount of qualified loans held by the taxpayer on November 16, 1985, multiplied by the interest rate applicable to that loan on November 16, 1985, multiplied by the foreign withholding tax rate applicable to interest payable with respect to that loan on November 16, 1985. The "applicable interest rate adjustment" equals the ratio of the weighted average London Interbank Offer Rate (LIBOR) for the taxable year in question to LIBOR on November 16, 1985. In the case of post-1989 qualified loans, the applicable interest rate adjustment equals the ratio of LIBOR on the last day of the first taxable year beginning after 1988 to LIBOR on November 16, 1985.

A limited transitional rule relating to the separate limitation for passive income also is provided.

Revenue Effect

The provisions are estimated to increase fiscal year budget receipts by $350 million in 1987, $594 million in 1988, $619 million in 1989, $672 million in 1990, and $712 million in 1991.

B. Source Rules

1. Determination of Source in Case of Sales of Personal Property (sec. 911 of the bill and secs. 861, 862, and new sec. 865 of the Code)

Present Law

Overview

Rules determining the source of income are important because the United States acknowledges that foreign countries have the first right to tax foreign income, but the United States generally imposes its full tax on U.S. income. With respect to foreign persons, the source rules are primarily important in determining the income over which the U.S. asserts tax jurisdiction (foreign persons are subject to U.S. tax on their U.S. source income and certain foreign source income that is effectively connected with a U.S. trade or business). Because the United States generally taxes the worldwide income of U.S. persons, the source rules are primarily important for U.S. persons in determining foreign source taxable income and, thus, in determining their foreign tax credit limitation. A premise of the foreign tax credit is that it should not reduce a taxpayer's U.S. tax on its U.S. income, only a taxpayer's U.S. tax on its foreign income. For the foreign tax credit mechanism to function, then, every item of income must have a source: that is, it must arise either within the United States or without the United States.

Income derived from purchase and resale of property

Income derived from the purchase and resale of personal property, both tangible and intangible, generally is sourced at the location where the sale occurs. The place of sale generally is deemed to be the place where title to the property passes to the purchaser (the "title passage" rule). To the extent personal property is depreciable or subject to other basis adjustments (e.g., amortization), the gain attributable to the recapture of such adjustments is also sourced on the basis of the place of sale.

One type of foreign source income derived by a foreign person that is subject to U.S. tax is the sale or exchange of inventory property if the foreign person has an office or other fixed place of business within the United States, such income is attributable to such office or other fixed place of business, and the sale or exchange is conducted through such office or other fixed place of business. This income is not, however, subject to U.S. tax if the property is sold or exchanged for use, consumption, or disposition outside the United States and an office or other fixed place of business of the taxpayer outside the United States has materially participated in the sale.

Income derived from manufacture and sale of property

Income derived from the manufacture of products in one country and their sale in a second country is treated as having a divided source. Under Treasury regulations, half of such income generally is sourced in the country of manufacture, and half of the income is sourced on the basis of the place of sale (determined under the title passage rule). The division of the income between manufacturing and selling activities must be made on the basis of an independent factory price rather than on a 50/50 basis, if such a price exists.

Income derived from intangible property

Royalty income derived from the license of intangible property generally is sourced in the country of use. For certain purposes, income derived from the sale of intangible property for an amount contingent on the use of the intangible is also sourced as if it were royalty income.

Withholding on certain intangible income

Present law provides that certain types of U.S. source income that are not effectively connected with the conduct of a trade or business in the United States are subject to U.S. tax on a gross basis. This method of taxation is generally based on the premise that the foreign person does not have sufficient presence in the United States to allow for an accurate determination of the foreign person's expenses in order to tax the person on a net basis.

One of these types of income is gains from the sale of certain intangible property to the extent that the payments for the intangible property are contingent on the productivity, use, or disposition of such property (sec. 871(a)(1)(D)). A related provision (sec. 871(e)) treats gain on the sale of intangible property as being contingent on the productivity, use, or disposition of such property if more than 50 percent of such gain is actually from payments which are so contingent. This related provision also treats those gains as royalties for purposes of determining their source.

Reasons for Change

Although the committee is reevaluating present law's source rules for income derived from sales of noninventory personal property, the committee is not convinced the title passage rule should be repealed for sales of inventory property. The committee is concerned that the repeal of the title passage rule for sales of inventory property would create difficulties for U.S. businesses to compete in international commerce. Moreover, the committee recognizes that with the substantial trade deficits of the United States, it does not want to impose any obstacles on U.S. businesses that may exacerbate the problems of U.S. competitiveness abroad.

However, in cases where manipulation of the title passage rule is relatively easy, (for example, sales of portfolio stock investments) the committee believes that the residence of the seller should govern the source of the income since the underlying activity is generally performed in the seller's residence, only the title is passed outside that residence. Nonetheless, the committee is concerned that a strict residence-of-the-seller rule may treat income

that should properly be foreign source as U.S. source. The committee does not intend that a taxpayer with an active business in a legitimate taxing jurisdiction that derives income connected with that business generate only U.S. source income. For example, the committee believes that income that a U.S. corporation generates in a foreign country through a fixed place of business should generally be local source income as long as the foreign country is not a tax haven with respect to the income at issue. Similarly, the committee believes that income derived from the disposition of business assets (for example, recapture income) should be sourced in the jurisdiction in which those assets were used in order to reflect the location of the economic activity generating the income.

The committee is also concerned with the application of the title passage rule as it applies to foreign persons. The committee is aware that some foreign corporations with U.S. branches (and to a lesser extent some nonresident individuals) are able to engage in significant business operations through a fixed place of business in the United States and avoid paying U.S. tax. This is accomplished through use of the title passage rule to generate non-U.S. source income. The committee is concerned that these practices erode the U.S. tax base and believes the title passage should be eliminated in these cases. The committee recognizes that other jurisdictions may tax this income on a source basis and is willing to cede primary tax jurisdiction in these cases as long as the property is not to be used within the United States.

The committee also believes that, to the extent payments from the sale of intangible property are contingent on the use of such property, the income is more in the nature of a royalty for the use of property than gain from an outright sale of such property. The committee believes, therefore, in these circumstances, the source rules governing royalties should apply.

Explanation of Provisions

Overview

The bill provides that income derived from the sale of personal property, tangible or intangible, other than inventory property and depreciable personal property, by a U.S. resident is generally sourced in the United States. Similar income derived by a nonresident generally is treated as foreign source. For purposes of the bill, the term sale includes an exchange or other disposition. Also, any possession of the United States is treated as a foreign country for purposes of this provision. Income that U.S. persons derive from the sale of inventory property, as defined in Code section 1221(1), continues to be sourced under present law (i.e., the title passage rule). Income derived from the sale of depreciable personal property is sourced pursuant to the rules described below.

The bill generally provides that an individual is a resident of the United States for this purpose if the individual has a tax home (as defined in Code sec. 911(d)(3)) in the United States. The bill provides that any corporation, partnership, trust, or estate which is a United States person (as defined in sec. 7701(a)(30)) generally is a U.S. resident for this purpose. All other individuals and entities generally are nonresidents for purposes of these source rules.

Special rules for U.S. persons

The bill contains an exception to the above described residence rules for U.S. citizens and resident aliens. The exception provides that U.S. citizens and resident aliens are not treated as nonresidents with respect to any sale of personal property unless the gain from the sale is actually taxed at a rate equal to or exceeding 10 percent in a foreign country. Thus, a U.S. citizen or resident alien cannot maintain a tax home in another country, sell his personal property, claim residency in such country, and generate foreign source income unless the person actually pays tax on the income from such sale to a foreign country at a 10 percent rate or higher.

The bill also provides two special rules for gains derived by U.S. residents. The first special rule provides that U.S. residents that derive income from sales of personal property (other than inventory property) attributable to an office or other fixed place of business maintained outside the United States generate foreign source income. This rule does not apply, however, if the income from the sale is not actually taxed at a 10 percent rate or higher in a foreign country. This special rule is designed to reflect the committee's general intention that the source of income from substantative operations is the location of those operations. The bill provides that current law principles are to apply in determining when sales are attributable to an office or other fixed place of business.

The second special rule provides that if a U.S. resident sells stock of an affiliate in the foreign country in which the affiliate derived from the active conduct of a trade or business more than 50 percent of its gross income for the 3-year period ending with the close of the affiliate's taxable year immediately preceding the year during which the sale occurred, any gain from the sale is foreign source. Affiliate, for this purpose, means any corporation (including a foreign corporation) whose stock (both voting power and value) is at least 80 percent owned.

The committee is aware that some of the source rules in the bill may conflict with source rules prescribed in U.S. income tax treaties. The source rules in the bill reflect the committee's policy that income not taxed, or not likely to be taxed, by a foreign country generally should not be treated as foreign source income for purposes of the foreign tax credit limitations. The committee does not intend that treaty source rules should apply in a manner which would frustrate the policy underlying the source rules in the bill that untaxed income not increase a U.S. taxpayer's foreign tax credit limitation. The committee intends this treatment for all of the bill's source rules, not only those governing sales of personal property.

Income derived from the sale of depreciable personal property

Subject to a special rule, the bill provides that gain to the extent of prior depreciation deductions from the sale of depreciable personal property is sourced in the United States if the depreciation deductions giving rise to such income were previously allocated against U.S. source income. If the deductions giving rise to such income were previously allocated against foreign source income, gain from such sales (to the extent of prior deductions) is sourced

without the United States. Any gain in excess of prior depreciation deductions is sourced pursuant to present law, i.e., sourced pursuant to the title passage rule.

Depreciation deductions, as defined by the bill, mean any depreciation or amortization or any other deduction allowable under any provision of the Code which treats an otherwise capital expenditure as a deductible expense. Depreciable personal property, as defined in the bill, means any personal property if the adjusted basis of the property includes depreciation adjustments. Depreciation adjustments are adjustments reflected in the adjusted basis of any property on account of depreciation deductions (whether allowed with respect to such property or other property and whether allowed to the taxpayer or to any other person).

The bill provides a special rule for purposes of determining the source of income from the sale of certain depreciable personal property. This rule provides that if personal property is either used predominantly in the United States or predominantly outside the United States for any taxable year, the taxpayer must treat the allowable deductions for such year as being allocable entirely against U.S. source or foreign source income, as the case may be. This rule is provided so as not to require a segregation of previously allowable deductions if the person knows the property was used predominantly in the United States or predominantly outside the United States, as the case may be. A segregation of allowable deductions is required, however, for certain personal property generally used outside the United States (personal property described in sec. 48(a)(2)(B)).

Income derived from the sale of intangible property

The bill provides that in the case of income derived from the sale of intangible property, to the extent the payments are not contingent on the productivity, use, or disposition of the intangible, the general rule of this provision applies. That is, income derived from such sales is sourced in the country of the seller's residence. If payments are contingent on productivity, use, or disposition, the source rules applicable to royalties apply. For purposes of the bill, intangible property is any patent, copyright, secret process or formula, goodwill, trademark, trade name or other like property. Notwithstanding the general rule, income attributable to the sale of goodwill is sourced where the goodwill was generated.

Income derived from the sale of personal property by foreign persons

In the case of nonresidents, the bill repeals the title passage rule with respect to sales of all personal property (except for foreign tax credit purposes). The term nonresident is defined pursuant to the bill's general definition. The bill provides that income derived from sales of personal property that are attributable to an office or other fixed place of business maintained in the United States by a nonresident is generally treated as U.S. source (except for foreign tax credit purposes). Pursuant to the Code's general rules defining effectively connected income, such income is considered effectively connected and will be subject to U.S. tax. The bill provides, however, that if a source country imposes tax on such income, the income

is treated as foreign source for purposes of section 906 (so as to allow the nonresident a foreign tax credit). Current law principles are to apply in determining when sales are attributable to an office or other fixed place of business.

Income derived by nonresidents that is treated as U.S. source by the rules described above is not treated as U.S. source, however, if the property is sold or exchanged for use, consumption, or disposition outside the United States and an office or other fixed place of business maintained outside the United States by such person materially participates in the sale.

The bill clarifies that gain from the sale of stock in a controlled foreign corporation by a U.S. shareholder that is treated under section 1248(a) as a dividend is sourced pursuant to the source provisions governing dividends (generally residence of the payor).

The bill provides that regulations are to be prescribed by the Secretary carrying out the purposes of the bill's provisions including the application of the bill's provisions to income derived from trading in futures contracts, forward contracts, options contracts, and similar securities.

The bill repeals section 871(e) (relating to the treatment of certain payments from the sale of intangible property to the extent that such payments are contingent on the productivity, use, or disposition of such property). By repealing section 871(e), taxpayers are to segregate the gain from the sale or exchange of applicable intangible property into gain contingent on the productivity, use, or disposition of such property and gain which is not so contingent. Withholding is required only with respect to U.S. source payments that are contingent on the productivity, use or disposition of such property.

Effective Date

The provisions affecting foreign persons (other than controlled foreign corporations) are effective for transactions after March 18, 1986. The provisions affecting U.S. persons and controlled foreign corporations are effective in taxable years beginning after December 31, 1986.

Revenue Effect

The provisions are estimated to increase fiscal year budget receipts by less than $5 million annually.

2. 80–20 Dividend and Interest Rules (sec. 912 of the bill and secs. 861, 862, 871, 881, 1441, and 1442 of the Code)

Present Law

Under present law, if U.S. source dividends and interest paid to foreign persons are not effectively connected with the conduct of a trade or business within the United States the withholding agent (which is generally the payor of such income) is generally required to withhold tax on the gross amount of such income at a rate of 30 percent (secs. 871(a) and 881(a)). The withholding rate of 30 percent may be reduced or eliminated by tax treaties between the United States and a foreign country. Furthermore, withholding is not re-

quired on certain items of U.S. source interest income. For instance, the Tax Reform Act of 1984 eliminated withholding on U.S. source portfolio interest. The United States does not impose any withholding tax on foreign source dividend and interest payments to foreign persons, even if the payments are from U.S. persons.

Dividend and interest income generally is sourced in the country of incorporation of the payor. However, if a U.S. corporation earns more than 80 percent of its income from foreign sources (such a corporation is referred to as an "80-20 company"), all dividends and interest paid by that corporation are treated as foreign source income. Foreign countries generally do not tax dividends and interest paid by U.S. corporations to U.S. persons even though those dividends and interest may be foreign source under these rules. This exception to the country of the payor source rule similarly applies to resident alien individuals. That is, if a resident alien receives more than 80 percent of his income from foreign sources, interest paid by that individual is treated as foreign source.

Other exceptions to the country-of-incorporation source rules are designed as tax exemptions for limited classes of income earned by foreign persons. For instance, interest on foreign persons' U.S. bank accounts and deposits is exempt from U.S. withholding tax under current law. The current method of exempting this income is to treat it as foreign source.

Reasons for Change

The committee is concerned that the present rules for interest and dividends paid by 80-20 companies cede primary tax jurisdiction away from the United States for income that should bear U.S. tax. For example, interest payments by an 80-20 company doing business in a foreign country generally are not subject to U.S. tax when received by foreign persons. Foreign recipients pay no U.S. tax on any of the income even though up to 20 percent of the payor's income is from U.S. sources. Similarly, foreign persons are able to interpose between themselves an 80-20 company to own the stock of a domestic operating subsidiary and the stock of a foreign operating subsidiary to shelter dividends from the domestic subsidiary from U.S. withholding tax. If the foreign persons own the stock of the domestic subsidiary themselves, a U.S. withholding tax is imposed. By using a holding company, however, to receive the dividends U.S. tax is avoided if the dividends from the foreign operating subsidiary constitute at least 80 percent of the holding company's income.

Similarly, the present treatment of interest and dividends paid by 80-20 companies artificially inflates U.S. persons' foreign source income for foreign tax credit limitation purposes. For example, if U.S. persons own the stock of an 80-20 company, the 80-20 company can distribute foreign source dividends and interest to those U.S. persons. The U.S. shareholders' foreign tax credit limitations are increased by the full amount of the income inclusion as a result. This is true even though up to 20 percent of the earnings from which the dividends and interest are derived may have been U.S. source to the 80-20 company. Excess foreign tax credits from other operations may then be used to shelter from U.S. tax at the share-

holder level all the dividends and interest paid by the 80-20 company. The committee believes that income earned by an 80-20 company should retain its source when paid out as interest or dividends and such income should be subject to U.S. tax when attributable to U.S. sources.

The committee also believes the present 80-20 rule is inappropriate in the case of individuals. If an individual receives any U.S. income, U.S. tax should not be foregone upon interest payments to foreign persons merely because the individual also earns substantial foreign source income.

Furthermore, in the committee's view, where it is desirable to provide a U.S. tax exemption for specific classes of interest income, it should generally be done directly rather than through modifications to the general source rules. The committee, therefore, grants overt exemptions for appropriate classes of income.

Explanation of Provision

The bill provides that interest and dividends paid by an 80-20 company are subject to a look-through rule that bases the source of those dividends and interest on the source of the income earned by the 80-20 company. These rules are to apply to both foreign and U.S. recipients.

In the case of interest paid by an 80-20 company, the amount treated as U.S. source is the ratio of gross income derived from U.S. sources, for the three-year period (or for the period of the corporation's existence, if shorter) ending with the close of the taxable year of such corporation preceding the year of payment of such interest to total gross income of the company.

For interest treated as U.S. source, the Code's general tax and withholding rules will apply. That is, U.S. source interest paid to foreign persons is subject to the taxation rules of sections 871 and 881 and the withholding provisions of sections 1441 and 1442.

In the case of dividends paid by an 80-20 company, the amount of the dividend treated as U.S. source is determined by the ratio of the 80-20 company's gross income derived from U.S. sources for the three-year period (or for the period of the corporation's existence, if shorter) ending with the close of the taxable year of such corporation preceding the year of declaration of the dividends to total gross income of the company.

The bill's look through rule does not apply to dividends paid by a corporation that has an election in effect under Code section 936. Present law is therefore retained for dividends paid by such corporations: dividends paid by such corporations will continue to be treated as foreign source.

As in the case of interest treated as U.S. source under the bill, any amount of dividends treated as U.S. source under this provision is subject to the general tax and withholding rules of the Code if paid to foreign persons.

The bill similarly applies a look through rule for interest paid by a resident alien individual who derives more than 80 percent of his gross income from foreign sources. For interest payments made by such individuals, the amount treated as U.S. source is the ratio of gross income derived from U.S. sources by such individuals for the

three-year period ending with the close of the taxable year of such individuals preceding the payment of the interest to total gross income of the individuals.

These source rules apply before the application of the resourcing rules enacted in the Tax Reform Act of 1984. If a greater amount is treated as U.S. source under those provisions, however, such amount is to be treated as U.S. source (but only for foreign tax credit limitation purposes).

The bill further provides that certain other interest, although treated as U.S. source, is not subject to the withholding tax provided in sections 871 and 881. This interest, whether received by a nonresident alien individual or other foreign person, includes interest on deposits with persons carrying on the banking business, interest on deposits or withdrawable accounts with a Federal or State chartered savings institution as long as such interest is a deductible expense to the savings institution under section 591, and interest on amounts held by an insurance company under an agreement to pay interest thereon, but only if such interest is not effectively connected with the conduct of a trade or business within the United States by the recipient of the interest. The bill also exempts from withholding tax the income derived by a foreign central bank of issue from bankers' acceptances. Under present law, these types of interest income are treated as foreign source income and thus are generally not subject to U.S. tax if paid to foreign persons; the bill treats them as U.S. source income but excludes them from withholding.

Effective Date

The provision is effective for dividends and interest paid in taxable years beginning after December 31, 1986.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by less than $5 million annually.

3. Special Rules for Transportation Income (sec. 913 of the bill and secs. 861, 863, 871, 872, 882, and 883 and new sec. 886 of the Code)

Present Law

Overview

In general, the United States taxes the worldwide income of U.S. persons whether the income is derived from sources within or without the United States. On the other hand, nonresident aliens and foreign corporations (even those which are subsidiaries of U.S. companies) generally are taxed by the United States only on their U.S. source income and income effectively connected with a U.S. trade or business. To eliminate double taxation, the United States permits foreign income taxes to offset U.S. tax imposed on foreign source income.

The U.S. tax laws contain a number of special rules which result in international transportation income, of both U.S. and foreign

persons, being subject to very little U.S. tax. Foreign countries often tax U.S. persons on income from foreign shipping operations.

Source rule for transportation income

Under Treasury regulations, income or loss derived from providing transportation services generally is allocated between U.S. and foreign sources in proportion to the expenses incurred in providing the services. Expenses incurred outside the territorial waters of the United States are treated as foreign expenses for purposes of this calculation. Under the Tax Reform Act of 1984, all transportation income attributable to transportation which begins and ends in the United States is treated as U.S. source income. Transportation income attributable to transportation which begins in the United States and ends in a U.S. possession (or which begins in a U.S. possession and ends in the United States) generally is treated as 50-percent U.S. source income and 50-percent foreign source income. These provisions apply to both U.S. and foreign persons.

For purposes of the above provisions, transportation income is defined as any income derived from, or in connection with, the use, or hiring or leasing for use, of a vessel or aircraft or the performance of services directly related to the use of such vessel or aircraft. Thus, these source rules apply to transportation income attributable to both rental income (bareboat charter hire) and transportation services income (time or voyage charter hire). Also, these source rules apply both to companies earning transportation income and their employees, so that they apply to, for example, the wages of personnel on ships. Transportation income includes income from transporting persons as well as income from transporting property. The term "vessel or aircraft" includes any container used in connection with a vessel or aircraft. Transportation income therefore includes income derived from the lease of a container vessel.

A special rule provides that income derived from the lease or disposition of vessels and aircraft that are constructed in the United States and leased to U.S. persons is treated as wholly U.S. source income. Expenses, losses, and deductions incurred in leasing such vessels and aircraft are also wholly U.S. source. These rules apply regardless of where the vessel or aircraft may be used.

Another special rule applies to transportation income and expenses associated with the lease of an aircraft (wherever constructed) to a regularly scheduled U.S. air carrier, to the extent the aircraft is used on routes between the United States and U.S. possessions. This rule provides that all income and expenses of the lessor will be treated as U.S. source.

Foreign flag transportation

Foreign owned transportation entities are often exempted from U.S. tax on their U.S. source income by reciprocal exemption (Code secs. 872(b)(1) and (2) and 883(a)(1) and (2)). Under the reciprocal exemption provisions, foreign owners are exempt from U.S. tax on U.S. source transportation income as long as the income is derived from the operation of a ship or aircraft documented or registered under the laws of a foreign country which grants an equivalent exemption for the transportation income of (or imposes no tax on the

income of) citizens of, and corporations organized in, the United States. The determination that a foreign country grants an equivalent exemption is usually confirmed by an exchange of notes between the two countries. Reciprocal exemptions under these provisions (or under treaties) are presently in effect with respect to most foreign countries. The reciprocal exemption provisions apply independently with respect to shipping and aircraft income. Thus, while in most cases both types of income are covered by the exemptions, in some cases the exemptions extend to one but not the other. As the exemptions apply to income derived from the operation of vessels (or aircraft), the Internal Revenue Service has held in Revenue Ruling 74-170, 1974-1 C.B. 175 that the exemptions do not apply to bareboat charter income.

In addition to the reciprocal exemption provided in the Code, the United States has approximately 40 income tax treaties providing for reciprocal exemption which would exempt transportation income from taxation by either country even if there were no statutory exemption. (Although there is substantial overlap, the scope of the typical treaty reciprocal exemption is somewhat different from the statutory reciprocal exemption.) These treaties are in effect with virtually all of the developed countries.

Despite the numerous Code and treaty reciprocal exemptions that the United States has granted, there are several countries that have not entered into exemption agreements with the United States. Consequently, these countries impose a tax (generally a gross basis tax) on the transportation income of U.S. persons.

In those cases where a reciprocal exemption under the Code or a treaty is not in effect, relatively little U.S. tax is imposed on the international transportation income of foreign persons since the present source rules described above for transportation income treat only a small portion of the total international transportation income as from U.S. sources. When a reciprocal exemption is not in force, the tax burden to U.S. persons earning transportation income is generally greater than that on persons from the non-exempting country who earn transportation income since foreign countries that tax transportation income generally impose the tax on income attributable to either the entire inbound or entire outbound leg of the trip whereas the United States imposes tax only on income earned within its territorial waters. U.S. transportation companies are, consequently, competitively disadvantaged vis-a-vis their foreign counterparts.

U.S.-controlled foreign flag transportation

Benefits from the Code and treaty reciprocal exemption provisions are derived not only by strictly foreign operators, but also by U.S. citizens and domestic corporations operating ships and aircraft through foreign subsidiaries. Most international shipping businesses of U.S. citizens and corporations are conducted through foreign subsidiaries. A substantial percentage of U.S.-owned foreign ships are registered in one of three countries: Liberia, the United Kingdom, or Panama, each of which qualifies for a reciprocal exemption.

Operators who incorporate abroad and who register their ships or aircraft in a foreign country with no intention of operating the

ships or aircraft in the domestic or foreign commerce of that foreign country are often referred to as using "flags of convenience". As a general rule, most flag of convenience shipping companies, including those registered in Liberia and Panama, are able to obtain the reciprocal exemption provided in the Code. Ships and aircraft registered in developed countries are generally entitled to the reciprocal tax exemption provided in the applicable U.S. tax treaty as well as the reciprocal exemption provided by the Code. Ships and aircraft registered in developed countries are also generally used in the domestic and foreign commerce of the country of registry.

Reasons for Change

Source of income

Under present law, a very small portion of international transportation income is U.S. source. Thus, most international transportation income is treated as foreign source. The committee believes that the U.S. source portion of international transportation income should generally be greater than the amount determined under present law and should be more comparable with the treatment of such income by other countries. Consistent with the committee's reevaluation of present law's source rules, the committee generally does not believe that persons should be able to generate foreign source income (or loss) unless the income (or loss) is generated within a foreign country's tax jurisdiction. The committee believes that the United States has the right to assert primary tax jurisdiction over income earned by its residents for income not within any other country's tax jurisdiction. (Present law's treatment of international transportation income as foreign source has the effect of relinquishing primary tax jurisdiction over this income).

The operation of present law has two effects. First, for U.S. persons, it has the effect of increasing the foreign tax credit limitation of the carrier and affiliates with income that does not have a nexus with any foreign country. (Conversely, losses treated as foreign source reduce the taxpayer's foreign tax credit limitation despite the absence of a nexus with a foreign country.) A carrier (or affiliates) with excess foreign tax credits from unrelated foreign operations may then utilize this increased foreign tax credit limitation to offset all or part of any U.S. tax that would otherwise be imposed on the transportation income. In this regard, a taxpayer with excess foreign tax credits has a competitive advantage over a taxpayer who does not have excess foreign tax credits. Secondly, present law's understatement of U.S. source income tends to subject foreign persons to too little U.S. tax on their transportation income. In the committee's view, the present rules do not allow for sufficient U.S. taxation when the United States should properly assert its tax jurisdiction.

The committee also believes that the present law provisions that allow a lessor to treat losses (or income) from the lease of an aircraft as wholly U.S. source income do not reflect economic reality. The committee believes that the income or loss should be foreign source under the rules that apply to U.S. taxpayers generally.

Tax on transportation income

The committee recognizes that, with the expansion of the source rules for transportation income, foreign persons may be subject to a greater amount of U.S. tax than under present law. In the committee's view, a gross-basis tax on U.S. source transportation income of foreign persons should be enacted. The committee intends, however, that the gross-basis tax only apply to residents of countries that impose a gross-basis tax on transportation income of U.S. persons. With the numerous reciprocal exemptions the United States has granted to other countries, the committee generally expects that no tax will be imposed on vessel and aircraft owners and operators resident in countries which are the United States' major trading partners and that the eligibility to claim a residence-based reciprocal exemption will not cause any noticeable disruption in common business practices. The committee anticipates that increased U.S. taxation of persons from foreign countries that impose a gross tax on U.S. persons will encourage those countries to enter into reciprocal exemptions with the United States.

Bareboat charter income is generally treated as periodical income and subject to withholding under present law. However, the committee recognizes that foreign persons earning such income may incur substantial expenses related thereto. In cases where another country taxes U.S. persons that earn this income on a gross basis, the committee believes the United States should tax this income on a gross basis. In other cases where a foreign country allows U.S. persons to account for their expenses in being taxed on this income, the committee believes foreign persons resident of these countries should be allowed to calculate their U.S. income tax liability by taking into account the expenses associated with the income. Moreover, the committee believes that bareboat charter income should be eligible for the reciprocal exemption when other countries exempt bareboat charter income earned by U.S. persons.

Reciprocal exemption

Currently, the reciprocal exemption provisions eliminate U.S. tax on foreign persons (even U.S.-controlled foreign corporations) by allowing exemptions based on country of documentation or registry, without regard to the residence of persons receiving the exemption or whether commerce is conducted in that country. This places U.S. persons with U.S.-based transportation operations and subject to U.S. tax at a competitive disadvantage vis-a-vis their foreign counterparts who claim exemption from U.S. tax and who are not taxed in their countries of residence or where the ships are registered. The current rules also limit the ability of the United States to enter into reciprocal exemptions where residents of the other country use leased vessels under another flag since such "flagging out" by residents of the other country limits the incentive of that country to exempt U.S. shippers. The reciprocal exemption provisions were not enacted to provide worldwide exemption from income tax. Instead, the reciprocal exemption provisions were enacted not only to promote international commerce but to reserve the right to impose tax on transportation income to the country of

residence of the taxpayer and, therefore, to eliminate double taxation.

The committee believes that using a flag of convenience in which to register a ship or aircraft circumvents the purpose of the reciprocal exemption. International practice, as reflected in tax treaties, is to provide tax benefits on the basis of reciprocity to residents of each contracting country.

Explanation of Provision

Source of transportation income

The bill provides that 50 percent of all transportation income attributable to transportation which begins or ends in the United States is U.S. source. The provision applies equally to U.S. and foreign persons. The bill modifies present law by excluding from transportation income the performance of services by alien seamen or airline employees with respect to transportation that begins or ends in the United States. Income from the performance of services is still transportation income for transportation that begins and ends in the United States and for transportation between the United States and a U.S. possession. As under present law, transportation income includes income from the bareboat charter hire of ships or aircraft. However, it is the committee's intention that transportation income not include income derived from the lease of a vessel if such vessel is not used to transport cargo or persons for hire. In such instances, the committee intends such income to be characterized as ocean activity income and be sourced in the country of residence of the person earning the income, as prescribed in section 915 of the bill.

The bill also repeals the special rule relating to the lease or disposition of vessels, aircraft, or spacecraft which are constructed in the United States (sec. 861(e)) and the special rule relating to the lease of an aircraft to a regularly scheduled U.S. air carrier (sec. 863(c)(2)(B)). The source of this income to the extent treated as transportation income is determined under the general rule described above.

The bill applies only to transportation income attributable to transportation that begins or ends in the United States. Thus, if a voyage that begins in Europe has intermediate foreign stops before it arrives in the United States, 50 percent of the income that is attributable to the cargo (or persons) carried from its port of origin or from any of the intermediate ports to the United States is considered U.S. source. Cargo or passengers off-loaded at intermediate ports before arrival in the United States will not give rise to U.S. source income.

The committee intends that income derived from furnishing round-trip travel of persons originating or ending in the United States by a carrier be treated as transportation income attributable to transportation that begins (for the outbound portion), or ends (for the inbound portion), in the United States under the bill's provision. Thus, 50 percent of the income attributable to the outbound transportation and 50 percent of the income attributable to the inbound transportation is U.S. source. For example, 50 percent of the income attributable to both ends of an air voyage from the United

States, to a foreign country, and back to the United States (or from a foreign country, to the United States, and back to a foreign country), is intended to be U.S. source.

Gross-basis tax

The bill generally provides for a four percent gross-basis income tax on the U.S. source transportation income of foreign persons. The tax is to be applied to gross U.S. source transportation income defined under present law, with the modifications described above. The bill provides that the four percent tax applies if the Code's 30 percent tax (under secs. 871 and 881) would otherwise apply (for example, to bareboat charter income).

Consistent with present law, however, if a foreign person is engaged in a trade or business in the United States and the foreign person's transportation income is effectively connected with that trade or business, the foreign person must, except as provided below, in lieu of paying the four percent gross-basis tax, file a U.S. tax return and pay tax on the basis of its net income. If a foreign person's transportation income is effectively connected with the conduct of a U.S. trade or business, such income, like other effectively connected income, will also be subject to the bill's branch profits tax (as provided in sec. 951). Similarly, however, if a foreign person's income is exempt from either the gross tax or net-basis tax because of a reciprocal exemption or treaty exemption, such income is also exempt from the branch profits tax.

The bill provides that individuals or corporations resident of a country that the Secretary determines imposes a gross-basis tax on transportation income of U.S. persons are not eligible to be taxed on a net basis. Thus, the gross tax applies to residents of such countries, even if their income would ordinarily be effectively connected with a U.S. trade or business. The bill provides that a foreign corporation is considered to be resident of a "listed" country if the corporation is organized in such a country, or if 50 percent or more of the value of the stock of such corporation is beneficially owned (within the principles of sec. 958 (a) and (b), relating to direct, indirect, and constructive ownership) by individuals who are residents of such countries. The committee intends that, in determining ultimate residence for purposes of allowing net basis taxation, U.S. shareholders of controlled foreign corporations not be considered residents of a listed country. Moreover, a corporation the stock of which is primarily and regularly traded on an established securities exchange in the country in which the corporation is organized is considered to be a resident of that country. In addition, if a parent corporation is organized in the same country as its subsidiary and its shares are primarily and regularly traded in the country in which its wholly-owned subsidiary is organized, both corporations are considered resident of such country.

Under the bill, foreign persons who are not resident of a listed country may elect to treat U.S. source transportation income that is not effectively connected with the conduct of a U.S. trade or business under general Code rules (i.e., income from bareboat charters) as income which is effectively connected with the conduct of a U.S. trade or business. This election is intended to allow operators or lessors of vessels or aircraft to account for their expenses in de-

termining their U.S. tax liability. Failure to elect means the bill's four percent gross tax applies to such income, unless otherwise exempt (as, for example, under the reciprocal exemption provided below).

The bill's gross-basis tax is to be collected by return. However, the committee will continue to study whether alternate, potentially more effective, methods of collecting the tax are feasible. The committee also intends that the Secretary monitor compliance with the bill's provisions and suggest to Congress alternative measures, such as withholding, if return filing does not result in adequate compliance.

The gross-basis tax is not intended to override U.S. income tax treaties with foreign countries. Therefore, a foreign person that is able to avail itself of a treaty exemption is not subject to the tax.

Reciprocal exemption

The bill modifies the present law reciprocal exemption by requiring foreign persons to be resident of a foreign country that reciprocally exempts U.S. persons rather than determining exemption based on the place of registry or documentation.

The bill provides that an alien individual must be a resident of a foreign country which grants U.S. citizens and domestic corporations an equivalent exemption in order for the alien individual to avail himself of the reciprocal exemption. The committee intends that a country which, as a result of a treaty with the United States, exempts U.S. citizens and domestic corporations from tax in that country on income derived from the operation of ships or aircraft, has an equivalent exemption, even though the treaty technically contains certain additional requirements other than residence such as U.S. registration or documentation of the ship or aircraft.

A foreign corporation must be organized in a foreign country which grants U.S. citizens and domestic corporations an equivalent exemption in order for the corporation to avail itself of the reciprocal exemption.

However, the bill further provides that, in the case of a foreign corporation claiming a reciprocal exemption, if 50 percent or more of the ultimate individual owners of the foreign corporation (determined under the principles of secs. 958(a) and 958(b)) are not residents of a foreign country that grants U.S. persons equivalent exemption (either by treaty or by reciprocal exemption), the foreign corporation is not able to claim the reciprocal exemption. It is the committee's intention that any treaty exemption for this purpose be based on residence.

For purposes of applying the 50-percent test to a foreign corporation (or other type of entity), if the foreign corporation is a U.S. controlled foreign corporation, the U.S. shareholders of the foreign corporation are treated as residents of the foreign country in which the corporation is organized. The bill also provides that the look-through rule does not apply to a foreign corporation (or a parent corporation if both corporations are organized in the same country) if the stock of the corporation (or of a parent corporation) is primarily and regularly traded on an established securities market in the foreign country in which the corporation is organized. For this pur-

pose, primary is intended to mean that more shares trade in the country of organization than in any other country.

The bill provides that the residence-based reciprocal exemption applies to gross income (instead of earnings as under present law). Therefore, the residence-based reciprocal exemption provisions apply to the gross-basis tax. The bill also expands the reciprocal exemption to include income derived from the lease of vessels or aircraft as long as a foreign country exempts U.S. persons from its tax on comparable income. The bill further provides regulatory authority to extend the reciprocal exemption by agreement on a partial basis. For example, if the United States and a foreign country agree that only regularly scheduled transportation be exempted from tax, then the Code's exemption can apply.

Effective Date

The provisions are generally effective for taxable years beginning after December 31, 1986. Leasing income will continue to be sourced under prior law for income attributable to an asset owned on January 1, 1986, if the asset was first leased before such date.

The bill provides that the ownership requirement of the special leasing rule is extended to January 1, 1987 for certain lessors that own Navy ships.

Revenue Effect

The provisions are estimated to increase fiscal year budget receipts by $8 million in 1987, $16 million in 1988, $18 million in 1989, $25 million in 1990, and $30 million in 1991.

4. Allocation and Apportionment of Interest and Other Expenses to Foreign Source Income (sec. 914 of the bill and sec. 864 of the Code)

Present Law

The Code provides, in general terms, that taxpayers, in computing net U.S. source and net foreign source income, are to deduct from U.S. and foreign source gross income the expenses, losses and other deductions properly apportioned or allocated thereto and a ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income.

Treasury regulation sec. 1.861–8 sets forth detailed allocation and apportionment rules for certain types of deductions, including those for interest expense (and research and development expenditures, which are the subject of another provision of this bill). These regulations, insofar as they govern interest expense, are based on the approach that money is fungible and that interest expense is properly attributable to all business activities and property of a taxpayer regardless of any specific purpose for incurring an obligation on which interest is paid. This approach recognizes that all activities and property require funds and that management has a great deal of flexibility as to the source and use of funds. Often, creditors of a taxpayer subject money advanced to the taxpayer to the risk of the taxpayer's entire activities and look to the general credit of the taxpayer for payment of the debt. When money is bor-

rowed for a specific purpose, such borrowing will generaliy free other funds for other purposes and it is reasonable under this approach to attribute part of the cost of borrowing to such other purposes.

In general, the regulation allows taxpayers to choose between two methods of allocating interest expense: an asset method and a gross income method. The regulation is based on the theory that normally, the deduction for interest expense relates more closely to the amount of capital utilized or invested in an activity or property than to the gross income generated therefrom, and therefore that the deduction for interest should normally be apportioned on the basis of asset values. Indebtedness permits the taxpayer to acquire or retain different kinds of assets which may produce substantially different yields of gross income in relation to their value. According to the theory of the regulation, apportionment of an interest deduction on such basis as gross income may not be reasonable. (Treas. Reg. sec. 1.861-8(e)(2)(v)). Therefore, the asset method is the preferred method.

Under the asset method, taxpayers generally may choose between two methods of evaluating assets, the tax book value method and the fair market value method. The tax book value method considers original cost for tax purposes less depreciation allowed for tax purposes. The fair market value method considers fair market value of assets, but it is available only if the taxpayer can show fair market value to the satisfaction of the Commissioner. Taxpayers who use the fair market value method may not switch to the tax book value method without the Commissioner's consent.

If any taxpayer that is a member of an affiliated group that files a consolidated return uses the gross income method, then all members of the group must use the same method. Under the gross income method, taxpayers generally apportion the deduction on the basis of U.S. and foreign gross income. (Treas. Reg. sec. 1.861-8(e)(2)(vi)). The allocation against foreign source income (or against U.S. source income) cannot be less than 50 percent of what the allocation would be if the taxpayer used the asset method.

Despite the general adoption of the approach that money is fungible, the regulation governing interest expense deductions provides a limited exception that allows taxpayers to trace interest expense to certain assets without treating that interest expense as fungible (Treas. Reg. sec. 1.861-8(e)(2)(iv)). That exception applies to a limited class of nonrecourse debt.

Under the regulations, interest expense incurred by an affiliated group of corporations that files a consolidated tax return is required to be apportioned between U.S. and foreign income on a separate company basis rather than on a consolidated group basis. This separate company apportionment rule conflicts with a Court of Claims case, *International Telephone & Telegraph Corp.* v. *United States* (79-2 USTC para. 9649), decided under the law in effect prior to the effective date of the Treasury regulations. The ITT case indicates that expenses that are not definitely allocable against U.S. or foreign gross income should be deducted from gross income of a consolidated group on a consolidated group basis. It appears that the ITT case has no effect in years to which the regulations apply.

The regulations generally allow tax-exempt income and assets generating tax-exempt income to be taken into account in allocating deductible expense. Banks and other financial institutions, which may deduct some interest used to carry tax-exempt assets, are the main beneficiaries of this rule.

Taxpayers generally allocate expenses other than interest expenses on a company-by-company basis.

Reasons for Change

Allocation and apportionment generally

The committee recognizes that proper rules governing the allocation and apportionment of expenses are essential to the proper functioning of the foreign tax credit limitation. Congress has heretofore addressed the expense side of the source question only in general terms, and has delegated to regulations the task of formulating rules governing expense allocation. The committee believes that these regulations have sometimes failed to reflect proper amounts of U.S. source and foreign source income.

In general, the committee does not believe that the approach of the existing regulations relating to the allocation of expense necessarily reflects economic reality. The committee believes that consideration of the expenses of the entire group of taxpayers that files a consolidated return is more likely to yield an appropriate determination of what expenses generate U.S. and foreign source gross income than is the separate taxpayer approach. In the case of corporations joining in the filing of a consolidated return, the committee believes that such consideration of group expenses can be accomplished with appropriate modifications of the separate company system of current law.

The committee has concluded that it is similarly appropriate to consider the entire group when taxpayers are eligible to be included in a consolidated return but do not file one. The committee does not want to allow the use of deconsolidation (or failure ever to consolidate, in the case of new ventures) to defeat the more appropriate expense rules that it has developed for consolidated groups. Moreover, the committee believes that affiliated groups of corporations, even those that do not choose to consolidate, are sufficiently economically interrelated that the imposition of this requirement will provide a more accurate measurement of their economic income than does the allocation of deductions on a separate company basis.

The committee believes that it is inappropriate to consider assets that generate tax-exempt income in allocating and apportioning expenses. It is immaterial whether exempt income is U.S. source or foreign source. The inclusion of exempt U.S. source income and assets in the expense allocation increases the amount of expense allocated to U.S. source income even though the income generated is not subject to U.S. tax.

Interest expense

The committee believes that it is necessary, in allocating a corporation's interest expense, to examine corporate stock that the interest payor holds to determine what kind of assets that stock repre-

sents. That is, the pure separate company approach has not proved adequate for the purpose of allocating interest expense. The pure separate company method of allocation has enabled taxpayers to limit artificially the interest expense allocated to foreign source income by adjusting the location of borrowing within the affiliated group. This may result in an overstatement of a taxpayer's net foreign source income and a resulting inappropriate increase in the amount of foreign tax credits available to an affiliated group of corporations. In effect, present law allows taxpayers to arrange to have interest expense reduce U.S. income, even though that interest expense funds foreign activities (or frees up other cash to fund foreign activities), the income from which is sheltered from U.S. tax by the foreign tax credit or by deferral. Thus, not only is no U.S. tax paid on the foreign investment, but the investment generates negative U.S. tax on U.S. income. That is, present law allows corporations within a consolidated group to reduce U.S. tax on U.S. income by borrowing money through one corporation rather than another.

The following examples illustrate the tax planning possibilities under current law.

Example 1

Assume that a U.S. corporation has $100 of U.S. and $100 of foreign assets, $20 of gross U.S income and $20 of gross foreign income. It incurs $20 of interest expense. Its net income is $20 ($40-$20). The interest expense reduces gross U.S. income and gross foreign income equally, resulting in $10 of each. The committee believes that the result of this example is appropriate.

Example 2

Under the present Treasury regulations, however, if all the taxpayer's assets generate gross U.S. income, then all the taxpayer's interest expense reduces gross U.S. income. To avoid having interest expense reduce foreign income, taxpayers can isolate interest expense in a corporation whose assets produce only U.S. income. This rule creates opportunities for tax avoidance, as shown in the following example.

The facts are the same as Example 1, above, except that the U.S. parent corporation initially borrows cash and contributes the cash to the capital of a U.S. holding company (the sole asset of the U.S. parent) which then invests in foreign and domestic assets. These two corporations file a consolidated return. The U.S. holding company has $100 of U.S. assets and $100 of foreign assets, $20 of gross U.S. income and $20 of gross foreign income. It incurs no interest expense. It pays all its $40 of earnings to the parent as a dividend. Under the 100-percent dividends received deduction, the parent has no income from this dividend, but it has $20 of interest expense. This $20 reduces only U.S. income.[1] The grcup has $20 of foreign income (the interest expense now will not reduce foreign income) and no U.S. income. If foreign tax credits shelter all the foreign income, the U.S. corporation can eliminate its U.S. tax.

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[1] The holding company is a U.S. asset in the hands of the parent under present law as long as less than 80 percent of its gross income from the prior three years is foreign source.

Example 3

In addition, as shown in the following example, the current rules requiring allocation on a separate company basis may furnish a trap for the unwary. Alternatively, the conflict (described above) between the ITT case and the Treasury regulations governing interest allocation may allow some taxpayers to choose the allocation method (consolidated group or separate company) that produces less U.S. tax.

U.S. corporation 1 owns $100 of U.S. business assets and U.S. corporation 2 owns $100 of assets that it uses in a foreign business. These corporations file a consolidated return. U.S. corporation 2 incurs $20 of interest expense, while corporation 1 incurs no interest expense. Under the regulations, this $20 would reduce only foreign gross income. Alternatively, under the theory of the ITT case, this $20 would reduce U.S. gross income and foreign gross income equally.

The committee believes that in cases where interest expense is directly allocable against a certain type of income, that expense should reduce that kind of income. Therefore, a rule like that now embodied in Treas. Reg. sec. 1.861-8(e)(2)(iv), that allows taxpayers to trace interest expense on certain nonrecourse debt to related assets, will continue to be warranted.

In addition, the committee believes that, in the case of a subsidiary corporation that borrows solely on its own credit, its interest expense supports only its own assets. For example, assume that a U.S. corporation with no debt acquires for cash a U.S. target corporation that has previously borrowed money. The acquiring company has foreign source income and foreign assets, while the target has neither. Strict application of the fungibility theory on a one-worldwide taxpayer basis would require allocation of some of the target's interest expense against foreign source income of the acquiring company. On these facts, the committee believes that it would be inappropriate to allocate the target's interest expense against the acquiring company's foreign source income. It is not clear to the committee that the target's interest expense supports the retention of foreign assets. The committee believes that direct allocation is appropriate on these facts if the borrower is using funds solely for its purposes and not for purposes of other members of the group. When funds find their way from the borrower to its affiliates, however, that rationale no longer applies. Similarly, if there is a guarantee of debt by a related party, and in the case of similar arrangements, the committee does not believe that taxpayers should be able to assert that the debt is the independent debt of the borrower for this purpose.

To the extent that interest expense is not directly allocable, the committee believes that it is appropriate for taxpayers to allocate and apportion interest expense on the basis that money is fungible. In this respect, the committee is adopting the theory of the Treasury Regulations governing the allocation of interest expense (see Treas. Reg. sec. 1.861-8(e)(2)(i)).

The committee believes that it is appropriate, to the extent that the tax law embodies a fungibility theory, to consider interest expense incurred by and the assets owned by foreign affiliates. Con-

sideration of interest expense and assets of foreign affiliates recognizes the possibility that a foreign affiliate may bear an appropriate amount of interest expense before any allocation of interest paid by U.S. affiliates. While foreign affiliates' borrowings have nothing to do with the amount of the U.S. group's interest deduction, those borrowings, the committee believes, may bear on the allocation of the interest expense that the U.S. group does incur.

Elimination of optional gross income method for allocating interest

The committee believes that the asset method more closely reflects economic reality than the gross income method. In this respect, the committee is adopting the theory of the Treasury Regulations concerning the general preferability of the asset method (see Treas. Reg. sec. 1.861–8(e)(2)(v)).

The gross income method has produced distortions under current law. For example, when taxpayers conduct their foreign operations through foreign subsidiaries, they allocate interest expense against only the net dividend they receive from the foreign subsidiary, not against the gross income that generated the net income that gave rise to the dividend. This rule tends to understate the allocation against foreign income and thus to overstate the allocation against U.S. income. This rule thus tends inappropriately to increase the foreign taxes that U.S. taxpayers can credit.

Improvement of asset method

Under current law, taxpayers owning corporate stock and using the asset method generally treat their basis in corporate stock as the amount to which they allocate expense. This stock basis amount does not reflect retained earnings. This failure to consider retained earnings has caused significant distortion. The bill's requirement that the asset method consider retained earnings of greater than 10-percent owned foreign and domestic corporations not included in the worldwide affiliated group for interest allocation purposes appropriately takes account of some changes in value attributable to taxpayers' interests in such corporations. Meanwhile, in the case of foreign and domestic members of the worldwide affiliated group, the asset method should consider the value of each member's assets (after proper exclusion of equity interests in other members) rather than the basis of an upper-tier member's stock in a lower-tier member.

The committee does not believe that a general statutory requirement of annual valuation of assets is practical or administrable. Nonetheless, when taxpayers are willing and able to make annual valuations, then the committee believes that an asset method based on annual valuation is appropriate, so long as taxpayers may not switch from the fair market value method to the tax book value method without a reason satisfactory to the Commissioner.

Expenses other than interest

While the committee believes that expenses directly allocable to an income producing activity should directly reduce income from that activity, the committee has concluded that, in the case of affiliated corporations, problems similar to those with the allocation of interest expense have arisen with other expenses. Thus, the com-

mittee has decided that the bill's general rule requiring treatment of an affiliated group as if it were one taxpayer is appropriate for expenses other than interest. For example, a U.S. parent corporation whose sole asset is stock of a U.S. holding company that owns U.S. and foreign assets may incur expenses other than interest or R&D expenses. The committee does not believe that, in such a case, it is necessarily appropriate to deduct all such expenses from U.S. source income. Instead, within the context of the separate company system of current law, it is appropriate to adopt a "look through" approach for purposes of apportioning expenses incurred by the payee of dividends that are properly allocable to the class of income consisting of such dividends, so long as this approach yields the same results that would obtain under a one-taxpayer approach.

Explanation of Provisions

Interest expenses

Generally, money is to be treated as fungible, and interest expenses are to be pro rated on the asset method. However, the bill treats interest expense of a U.S. member of a corporate group as supporting only assets of the borrower, absent a guarantee or similar arrangement. More specifically, a U.S. company that borrows without a guarantee is treated as using its interest expense to support only its assets, including, on a look-through basis, assets of corporations whose stock it owns. Absent a guarantee, its debt is not treated as supporting assets of upper-tier corporations (or brother-sister corporations). However, in the case of an unguaranteed debt, an "equalizing" rule operates to return the allocation of related parties' expenses to an approach consistent with fungibility to the extent possible.

The bill does not change the treatment of non-recourse debt that the current regulation treats as definitely related to specific property (Treas. Reg. sec. 1.861-8(e)(2)(iv)). The committee does not intend to preclude the Secretary from treating other debt, including recourse debt, as definitely related to specific property to the extent necessary to preserve the principles of this legislation.

The bill provides, subject to important exceptions, that for purposes of the foreign tax credit limitation of section 904, the taxable income of an affiliated group from sources outside the United States is to be determined by allocating and apportioning all interest expenses as if all members of the group and their 80-percent owned foreign subsidiaries were a single corporation. As a result, absent appropriate direct allocation of interest expense, the bill causes the amount of foreign source and U.S. source income on the consolidated return in each of the three numbered examples in the Reasons for Change section to be the same: because U.S. and foreign assets are equal and U.S. and foreign and income are equal in each example, after allocation of interest expense, the $20 of net income in each example would consist of $10 of foreign source income and $10 of U.S. source income. The committee intends that taxpayers not be able to reduce artificially allocation of interest expense to foreign source income through intercompany lending and directs therefore that regulations provide for appropriate treat-

ment in the case of interest payments among members of a worldwide affiliated group.

For the purpose of interest expense allocation, the bill includes within the affiliated group whose interest expenses and assets go into the allocation determination not only members of the U.S. consolidated group (or corporations eligible to consolidate), but also foreign corporations that would be eligible to consolidate were they not foreign, and section 936 companies (possessions corporations) that would be eligible to consolidate absent statutory prohibition. The bill does not allow U.S. corporations to deduct interest expense incurred by foreign corporations. Nonetheless, the bill considers foreign-borne interest expenses in allocating the interest deduction of the U.S. members of the group. Thus, interest expense allocated to foreign source income under the one worldwide taxpayer rule of the bill is reduced by any interest expense incurred by a foreign member of the worldwide affiliated group if that foreign-borne interest would have been allocated or apportioned to foreign source income of that foreign corporation under the principles of the bill if applied separately to such foreign members of the group.

For example, a U.S. parent company operates directly a U.S. business and owns a foreign operating subsidiary. The U.S. business and the foreign subsidiary each have $100 of assets. The foreign subsidiary earned $25 of net (pre-interest and pre-tax) foreign source income, but incurred $5 of interest expense. It distributes $20 to the parent as a dividend, and the parent has $20 of U.S. source income (pre-interest and pre-tax) from its U.S. business. The parent has no foreign income other than the dividend from its foreign subsidiary. The parent incurs $15 of interest expense that is not directly attributable to any particular income. Under present law, the $15 of interest expense is evenly divided between the parent's U.S. income and foreign income ($7.50 each). The parent, therefore, has $12.50 of taxable U.S. income, and $12.50 of taxable foreign income. If both these corporations were a single corporation, their combined $20 of interest expense would be allocated $10 against U.S. income and $10 against foreign income. Under the bill, therefore, the interest expense allocated against foreign income is $5. This is $20 of worldwide interest expense multiplied by 100/200, the ratio of foreign assets to worldwide assets, and reduced by the $5 of interest directly incurred by the foreign subsidiary. The remaining $10 of the parent's interest expense is allocated to U.S. sources. The parent has $10 of net taxable U.S. income, and $15 of taxable foreign income. The $5 of interest expense that the foreign subsidiary incurs does not reduce U.S. tax, but it enters into the allocation calculation.

The bill specifies that taxpayers are to allocate and apportion interest expense on the basis of assets rather than gross income. That is, the bill no longer allows taxpayers to use the optional gross income method of the current regulation (or any similar method) for allocating and apportioning interest.

The bill provides a special rule for certain unguaranteed debt of U.S. members of a group below the top corporate tier. In general, a U.S. corporation that is a member of an affiliated group and that incurs interest expense with respect to qualified debt (generally defined below to mean debt not guaranteed by a related party) may

elect to allocate and apportion interest incurred with respect to that qualified indebtedness under the bill's general rules as though the corporation incurring the expense were the ultimate U.S. parent corporation of an affiliated group consisting of that U.S. corporation and its direct and lower-tier subsidiaries. For this purpose, qualified indebtedness means borrowing from unrelated parties that is not guaranteed or in any other way facilitated by any corporation within the same worldwide affiliated group as the borrower. If one U.S. member of an affiliated group makes this election, this "look-down" treatment applies to all qualified interest of all U.S. members of the group.

In certain cases, transfers of funds from one affiliate to another have the effect of reducing qualified indebtedness. When a U.S. corporation seeking to take advantage of the qualified indebtedness rule distributes dividends or makes a return of capital distribution in a year to a member of its affiliated group in excess of the greater of its average annual dividend (computed as a percentage of each year's current earnings and profits) during the 5 preceding years (or such shorter period as the corporation has been in existence) or 25 percent of its average annual earnings and profits for the 5 preceding years (or such shorter period as the corporation has been in existence), the bill recharacterizes an amount of qualified indebtedness equal to the excess as nonqualified indebtedness. A similar rule obtains if a corporation that incurs otherwise qualified indebtedness deals with another member of the affiliated group on a non-arm's length basis. Upon conversion of qualified indebtedness to nonqualified indebtedness for this purpose, interest expense with respect to that debt is allocated on the basis of the worldwide group's assets and interest expense.

An equalization rule applies in cases where the qualified indebtedness rule has come into play. An affiliated group that contains a U.S. corporation that has used the qualified indebtedness rule to allocate interest expense is to allocate and apportion the interest expense (if any) incurred by members of the affiliated group with respect to non-qualified indebtedness first to foreign source income to the extent necessary to achieve (if possible) the total affiliated group allocation and apportionment of interest expense to foreign source income that would have resulted under the bill's general rule had the qualified indebtedness rule not come into play.

For example, a corporate group consists of a U.S. parent, a U.S. subsidiary, and a foreign subsidiary. Each subsidiary has $100 of physical assets. The U.S. subsidiary's assets produce only U.S. source income; the foreign subsidiary's assets produce only foreign source income. The parent has no assets other than stock of the subsidiaries. The U.S. subsidiary incurs $5 of interest expense with respect to qualified indebtedness. That expense is allocated against only U.S. source income. The foreign subsidiary incurs no interest expense. If the U.S. parent corporation incurs $5 of interest expense, the full $5 is allocated against foreign source income. That allocation is necessary to reach the allocation that would have resulted absent the qualified indebtedness rule.

If the parent in the above example had incurred only $4 of interest expense, the full $4 of its interest expense would be allocated

against foreign source income. Full equalization is not required in that case.

If the parent in the above example had incurred $7 of interest expense, the first $5 of its interest expense would be allocated against foreign source income. Thereupon, the remaining $2 would be allocated under the bill's general rule. One dollar would be allocated against U.S. source income, $1 against foreign source income. Of the parent's debt, $1 would be allocated against U.S. source income, $6 against foreign source. Of the group's debt, $6 would be allocated against each type of income.

The bill grants regulatory authority to treat other amounts that are economically the equivalent of interest as interest for this purpose. Similarly, the committee intends that amounts denominated as interest but that are not interest as an economic matter not be treated as interest for this purpose. In particular, the committee recognizes that deductions of life insurance companies described in section 807(c) (1), (2), (3), and (6) should not be treated as interest expenses for this purpose. In addition, this circumstance may arise where a foreign (or U.S.) affiliate incurs interest expense in a currency other than the dollar.

Expenses other than interest

In the case of expenses other than interest (or research) that are not directly allocable to specific income producing activities, the bill effectively treats the U.S. affiliated group as one taxpayer, but grants regulatory authority to the Secretary of the Treasury to provide exceptions, if any, as appropriate. That is, taxpayers are, in effect, to disregard stock of affiliates and interaffiliate debt. The committee believes that this intended result may be achieved under regulations that retain the separate company method of allocation of current law but that, unlike current law, treat stock in domestic subsidiary corporations as a foreign asset to the extent the domestic corporation (or its subsidiaries on a "look through" basis) earns foreign source income. The group treated as one taxpayer for purposes of allocating expenses other than interest is the U.S. group that consolidates or that is eligible to consolidate, not including foreign affiliates or possessions corporations. Treating a U.S. group as if it were one taxpayer for expenses that are not directly allocable, however, will not change the present law rules governing whether expenses are directly allocable. As under current law, expenses that a corporation at the lowest corporate tier (one with no subsidiaries) incurs only to earn its own income (and not to help affiliates earn income) will be allocated to its income only.

When a corporation owns stock in subsidiaries, it may incur some expenses that are allocable to specific income producing activities. For instance, a corporation that owns stock in subsidiaries may also conduct direct operations on its own behalf. Expenses incurred to conduct those operations are allocable, as under current law, to the income from those operations. If a corporation incurs expenses that are not directly allocable to specific income producing activities, the bill generally requires the allocation of those expenses under the "one-taxpayer" principles that apply to interest expenses. The bill does not treat such expenses as "fungible." The

bill requires instead that expenses not allocable to specific income producing activities be allocated or apportioned without regard to holding companies, corporate layers, or artificial structures. For example, the salary of the president of a U.S. corporation that only owns a U.S. holding company that holds both U.S. and foreign subsidiaries will be allocated (if appropriate) between U.S. and foreign source income as if the U.S. corporations were all one corporation. *See, e.g.*, Treas. Reg. sec. 1.861-8(b)(3) and (e)(4).

Similarly, the bill will generally not change the treatment of items such as labor costs or costs of materials, which, to the extent that they are elements of cost of goods sold, are generally not subject to allocation or apportionment.

Rules applicable to all expenses

The bill provides that tax-exempt assets and income associated therewith are not to be taken into account in allocating or apportioning any deductible expense. This rule applies to all expenses including interest. For this purpose, 80 percent of stock that pays dividends that are eligible for the 80-percent dividends received deduction is treated as a tax-exempt asset.

The bill provides a new rule for purposes of allocating and apportioning expenses on the basis of assets when the asset is stock in one of certain corporations. If a corporation is not included in the worldwide affiliated group (generally a corporation that is more than 10 but less than 80 percent owned), then, in general, for this purpose, the adjusted basis of an asset which is stock in such corporation in the hands of a U.S. shareholder (or in the hands of a foreign subsidiary that is part of the group) is to be increased by the amount of the earnings and profits of the corporation attributable to that stock and accumulated during the period the taxpayer held it. In the case of a deficit in earnings and profits of the corporation that arose during the period when the U.S. shareholder held the stock, that deficit is to reduce the adjusted basis of the asset in the hands of the shareholder. In that case, however, the deficit cannot reduce the adjusted basis of the asset below zero.

The bill's one-taxpayer rule also provides new treatment under the asset method for stock in affiliated U.S. companies. The committee intends that stock of affiliates and intercompany debt between domestic affiliates be disregarded under appropriate look-through rules prescribed by the Secretary. Therefore, as members of an affiliated U.S. group earn income that they retain, that income will be reflected in assets whose tax basis will be considered in the allocation of expenses under the asset method. This same approach is applied to stock of 80 percent owned foreign affiliates. Similarly, borrowings by 80-percent owned U.S. and foreign affiliates, unless used for current expenses, generally will be reflected in increased assets that those affiliates acquire.

Example

An example illustrates the operation of the one-taxpayer rule and the asset method change. A U.S. parent company has borrowed $360 with an obligation to pay annual interest of $36. The U.S. parent borrower owns two assets. One of its assets is stock of a domestic subsidiary; that stock has a basis in the parent's hands of

$600. The U.S. subsidiary in turn owns the following assets: U.S. assets which have a basis in its hands of $700, and foreign assets which have a basis in its hands of $100. The other asset of the U.S. parent (the borrower) is stock in a foreign corporation. The basis of the stock in the foreign corporation in the hands of the U.S. owner is $100. The foreign corporation also has retained earnings of $100. The foreign corporation has assets with a basis in its hands of $200. It has incurred no debt.

Under the bill, after a transition period, the interest expense allocation rules will operate on the basis of the affiliated group consisting of the U.S. parent corporation, U.S. subsidiary, and its foreign subsidiary. The parent will be treated in effect as owning directly the $700 of U.S. assets owned by the U.S. subsidiary and the $100 of foreign assets owned by the U.S. subsidiary. In addition, the parent will be treated as owning the $200 of foreign assets of the foreign subsidiary. Thus, the parent is treated as owning $700 of U.S. assets and $300 of foreign assets for the purpose of the asset method. Therefore, 70 percent of its interest expense ($700/$1000) will reduce U.S. source gross income. The parent corporation will allocate $10.80 (30 percent of $36) against foreign source income and $25.20 (70 percent of $36) against U.S. source income. The same result generally would obtain if the U.S. subsidiary had borrowed the money and paid the interest, so long as the parent guaranteed or otherwise facilitated the loan.

Regulations

The bill requires the Secretary to prescribe such regulations as may be necessary to carry out the purposes of these provisions. In particular, the committee intends that, in the case of an affiliated group of corporations that is eligible to file a consolidated return but that does not do so, the foreign source income of any member of the group shall not exceed the amount of foreign source income that would be attributable to that member if the group were a single corporation. For example, assume that two U.S. corporations, a parent corporation and its wholly owned subsidiary, although eligible to file a consolidated return, do not do so. The parent has $20 of gross income, all from sources within the United States, and incurs $20 of interest expense. The parent has no net income after interest expense. The subsidiary has $20 of gross income, all from sources without the United States, and incurs no interest expense. The subsidiary has $20 of net income. The committee intends that under regulations the foreign source income of this group of two corporations will not exceed what it would have been had they filed a consolidated return. Had they done so, the group would have had $10 of net U.S. source income, and $10 of net foreign source income. Therefore, the foreign source income of the subsidiary cannot exceed $10. It will be treated as earning $10 of U.S. source income and $10 of foreign source income.

In addition, the committee intends that regulations provide appropriate safeguards to prevent the transfer of assets from one consolidated group member to another to achieve a fair market value basis without recognition of gain (until the asset leaves the group).

The committee also intends that regulations be provided to prevent a domestic corporation allocating interest expense under the

qualified unguaranteed indebtedness rule from making the economic benefit of that qualified unguaranteed indebtedness available to other members of the affiliated group.

In addition, the committee intends that regulations provide for the apportionment of interest allocated to foreign source income among the various categories of foreign source income described in section 904(d)(1), such as passive income and active (overall limitation) income. In particular, these regulations should provide that interest expense will be allocated against the type of income (such as "active" overall limitation income or separate limitation passive income) that a particular corporation earns. In addition, the rules allocating expenses among baskets of income for foreign tax credit limitation purposes are to be consistent with those used for source purposes.

Effective Date

In general, these provisions apply to taxable years beginning after December 31, 1986. Transitional rules apply to the allocation of interest expense, however.

A general four-year "phase-in" transitional rule applies to all the elements of the interest expense allocation (including the change to consider an affiliated group as one taxpayer, the elimination of the gross income method, and the changes in the asset method). This "phase-in" rule provides that for the first four taxable years of the taxpayer beginning after December 31, 1986, the bill's interest expense allocation rules apply only to the extent that the average principal amount of the indebtedness owed by the U.S. taxpayer during the taxable year exceeds an "applicable percentage" of a base amount. The base amount is the U.S. taxpayer's debt outstanding on March 18, 1986. This four-year phase-in rule applies whether the taxpayer borrows from the same lender from which it borrowed on March 18, 1986, or from other lenders. In the case of the first taxable year, the applicable percentage is 80 percent; in the case of the second taxable year, the applicable percentage is 60 percent; in the case of the third taxable year, the applicable percentage is 40 percent; in the case of the fourth year, the applicable percentage is 20 percent.

Thus, for example, under the four-year "phase-in", assume that a calendar year taxpayer's debt outstanding on March 18, 1986, was $100. At all times during 1987, the taxpayer's outstanding debt is $80. The bill does not apply to any of that expense, because $80 does not exceed 80 percent of the $100 base amount. If the taxpayer's debt outstanding at all times during 1987 were $90, the bill would apply only to interest expenses incurred with respect to $10 of debt. The allocation rules of current law will apply to debt not allocated under the bill's rules during the transition period.

In addition, certain special effective date rules are provided.

Revenue Effect

The provisions are estimated expected to increase fiscal year budget receipts by $61 million in 1987, $130 million in 1988, $185 million in 1989, $231 million in 1990, and $279 million in 1991.

5. Source Rule for Space and Certain Ocean Activities (sec. 915 of the bill and secs. 861 and 863 of the Code)

Present Law

Activities conducted in space or outside the territorial waters of foreign countries may take many forms: manufacturing occurs in space, spacecraft and satellites are leased, personal services are performed in space, and payments are made for other actual business operations conducted in space, such as research and development. Similarly, income from activities conducted outside the territorial waters of foreign countries can take many of the same forms: lease income, personal service income and business income.

The source of space and "high seas" income depends under present law on the type of activity performed. Lease income is generally sourced in the place of use; personal service income is generally sourced in the location in which the services are performed; and manufacturing and other business income is generally sourced where the activity is performed. Therefore, because the equipment is generally used, the services generally performed and the activities generally conducted outside the United States, the predominant part of income from space and high-seas activities is generally treated as foreign source income under present law. This is because the United States today considers within its primary tax jurisdiction only the mainland boundaries of its States and its territorial waters.

A special rule (discussed in more detail in sec. 913 of the bill) provides that certain income from leasing vessels, aircraft, or spacecraft is U.S. source (Code sec. 861(e)).

Reasons for Change

The foreign tax credit rules are designed to prevent double taxation of income by the United States and foreign countries. The credit generally operates on the principle that the country in which income arises has the primary right to tax the income. In order to prevent the foreign tax credit from offsetting more than the U.S. tax on U.S. source income, the credit is limited to the taxpayer's pre-credit tax on its foreign source income. In view of the limited purposes of the foreign tax credit, the source rules used in computing the foreign tax credit limitation are generally designed to identify as foreign source income that income which might reasonably be subject to foreign tax.

The committee has reevaluated present law's policy in determining the source of various types of income (see for example, sec. 913, regarding the source of transportation income). The committee has concluded that retaining primary tax jurisdiction only over income generated within the United States' territorial waters is inappropriate. Accordingly, the committee believes the United States should assert primary tax jurisdiction over income earned by its residents that is not within any foreign country's taxing jurisdiction (i.e., a foreign country's mainland boundaries and its territorial waters). In the committee's view, the present law treatment of this income as foreign source allows taxpayers with excess foreign tax credits to shelter this income from U.S. tax. The committee be-

lieves that the U.S. policy of the foreign tax credit will be better served by these standards.

The committee does not believe the present rules governing the source of income are appropriate in their application to income derived from space or high-seas activities by U.S. residents. The committee notes that activities conducted in space have heretofore not been very prevalent. With this is mind, the committee believes that the Code's general source rules should be examined in their application to space activities. Moreover, when a U.S. taxpayer conducts activities in space or international waters, foreign countries generally do not tax the income. Thus, the foreign tax credit limitation is inflated by income that is not within any foreign country's tax jurisdiction. Furthermore, a taxpayer with excess foreign tax credits from other operations can eliminate all tax (U.S. and foreign) on this income (since foreign countries are not taxing the income) rather than merely double tax. Thus, the U.S. Treasury in effect pays the tax on this income. The committee recognizes, however, that telecommunications income has some potential to be taxed in a foreign country and believes that present law's source rules with respect to this income should be only partially modified.

The committee recognizes that sourcing income derived from space and high-seas activities in the country of residence may provide an unintended incentive for U.S. persons to conduct such activities through controlled foreign corporations. In these circumstances, the committee believes that the corporations should be considered resident in the jurisdiction of the corporation's owners.

Explanation of Provision

The bill provides that all income derived from space or ocean activities is sourced in the country of residence of the person generating the income: income derived by United States persons (as defined in sec. 7701(a)(30)) is U.S. source income and income derived by persons other than U.S. persons is sourced outside the United States.

The bill provides, however, an anti-conduit provision in the case of certain foreign corporations. A foreign corporation is to be treated as a U.S. person if 50 percent or more in value, or in voting power, of the corporation is owned (within the meaning of sec. 958(a)) or considered as owned (under the principles of sec. 958(b)) by U.S. persons. Thus, U.S. persons cannot incorporate a foreign corporation in order to be taxed as a nonresident of the United States for this purpose. This provision applies regardless of the number of persons interposed between the corporation earning the income and its ultimate owners.

Space or ocean activities as defined by the bill include any activities conducted in space, and on or beneath water not within the jurisdiction (as recognized by the United States) of any country including the United States or its possessions. The term ocean activities also includes any activities performed in Antarctica. For example, the committee intends that the term space or ocean activities include the performance and provision of services in space or on or beneath the ocean, the leasing of equipment including spacecraft located in space or on or beneath the ocean, the licensing of tech-

nology or other intangibles for use in space or on or beneath the ocean, and the manufacturing of property in space or on or beneath the ocean. The committee intends the term ocean activities to further include the leasing of a vessel if such vessel does not transport cargo or persons for hire between ports-of-call. For example, the income earned by a lessor of a vessel chartered by a corporation that is to engage only in research activities in the ocean is intended by the committee to be high-seas income. In these circumstances, the committee does not intend the lessors to earn transportation income since the operators of the vessels are not engaged in transporting cargo or persons between ports-of-call.

The bill provides for regulations to describe other activities that may be considered space or ocean activities. For example, the committee intends that underwriting income from the insurance of risks on activities conducted in space or on or beneath the ocean to be treated as space or ocean activities. The committee does not intend the selling of property on the high seas to be considered space or ocean activity (i.e., the bill does not override the title passage rule).

Space or ocean activities do not include any activity which gives rise to transportation income (as defined in sec. 863(c)) or any activity with respect to mines, oil and gas wells, or other natural deposits to the extent the mines or wells are located within the jurisdiction (as recognized by the United States) of any country, including the United States and its possessions. In the case of mines, oil and gas wells, or other natural deposits to the extent such mines or wells are not within the jurisdiction of the United States, U.S. possessions, or any foreign country, the committee does intend the leasing of drilling rigs, the extraction of minerals, and the performance and provision of services related thereto to be ocean activities.

The bill also excludes from the definition of space or ocean activities international communications income. The bill provides that international communications income is to be sourced 50 percent in the United States and 50 percent foreign to the extent the income is attributable to communications between the United States and a foreign country. If the communication is between two points within the United States, the income attributable thereto is to be sourced entirely as U.S. source income. The committee intends the latter result even if the communication is routed through a satellite located in space, regardless of the satellite's location. If the communication is between the United States and an airborne plane or a vessel at sea, the committee intends the communication to be treated as between two U.S. points and, thus, to be sourced in the United States. Finally, if the communication is between two foreign locations, the committee intends income attributable thereto to be foreign source. The committee intends that international communication income include income attributable to any transmission between two countries of signals, images, sounds, or data transmitted in whole or in part by buried or underwater cable or by satellite. For example, the term includes income derived from the transmission of telephone calls.

As provided in sec. 813 of the bill, Code sec. 861(e), relating to certain income from leasing vessels or spacecraft that is treated as wholly U.S. source, is repealed.

Effective Date

The provision is effective for income earned in taxable years beginning after December 31, 1986.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by less than $5 million annually.

C. Taxation of U.S. Shareholders of Foreign Corporations

1. Expansion of Subpart F Income Subject to Current U.S. Taxation (secs. 921 and 989 of the bill and sec. 954 of the Code)

Present Law

In general

Two different sets of U.S. tax rules apply to American taxpayers that control business operations in foreign countries. The choice of whether the business operations are conducted directly, for example, through a foreign branch, or indirectly through a separately incorporated foreign company, determines which rules apply. (To the extent that foreign corporations operate in the United States rather than in foreign countries, they generally pay U.S. tax like U.S. corporations.)

Direct operations—current tax

The income from foreign business operations that are conducted directly appears on the U.S. tax return for the year the taxpayer earns it. The United States generally taxes that income currently, as it does U.S. income. The foreign tax credit, discussed above, may reduce or eliminate the U.S. tax on the foreign income, however.

Indirect operations—generally tax deferral

In general, a U.S. shareholder of a foreign corporation pays no U.S. tax on the income from those operations until the foreign corporation sends its income home (repatriates it) to America. The income appears on the U.S. shareholder's tax return for the year it comes home, and the United States generally collects the tax on it then. The foreign tax credit may reduce or eliminate the U.S. tax, however. (The foreign corporation itself will not pay U.S. tax unless it has income effectively connected with a trade or business carried on in the United States, or has certain generally passive types of U.S. source income.)

Indirect operations—current tax for some income

Deferral of U.S. tax on income of a controlled foreign corporation is not available for certain kinds of income (referred to here as "subpart F income") under the Code's subpart F provisions. Subpart F income is generally income that is relatively movable from one taxing jurisdiction to another in order to reduce U.S. and foreign tax liability. When a U.S.-controlled foreign corporation earns subpart F income, the United States will generally tax the corporation's 10-percent U.S. shareholders currently on their pro rata share of the subpart F income. In effect, the Code treats the U.S. shareholders as having received a current dividend to the extent of

the corporation's subpart F income. In this case, too, the foreign tax credit may reduce or eliminate the U.S. tax.

Subpart F income presently consists of income from the insurance of U.S. risks (defined in sec. 953), foreign base company income (defined in sec. 954), and certain income relating to international boycotts and illegal payments. Foreign base company income is itself subdivided into five categories. One major category is foreign personal holding company income. For subpart F purposes, foreign personal holding company income consists generally of passive income such as interest, dividends, net gains from sales of stock and securities, related party factoring income, and some rents and royalties. Net gains from certain commodities futures transactions are foreign personal holding company income unless they arise out of certain bona fide hedging transactions. An exclusion from subpart F foreign personal holding company income is provided for rents and royalties received from unrelated persons in the active conduct of a trade or business. Under this active trade or business test, rents from a retail car-leasing business involving substantial maintenance, repair, and marketing activities, for example, would be excluded from subpart F, while rental income from lease-financing transactions would not. Exclusions are also provided for dividends, interest, and gains derived from unrelated persons by a banking, financing, or similar business, and dividends, interest, and gains received by an insurance company from its investment of unearned premiums and reserves. Additional exclusions from subpart F foreign personal holding company income are provided for (1) certain dividends and interest received from a related person organized and operating in the same foreign country as the recipient, (2) interest paid between related persons that are each engaged in the conduct of a banking, financing, or similar business predominantly with unrelated persons, and (3) rents and royalties received from a related person for the use of property within the country in which the recipient was created or organized.

Other categories of foreign base company income include foreign base company sales and services income, consisting respectively of income from related party sales routed through the income recipient's country if that country is neither the origin nor the destination of the goods, and income from services performed outside the country of the corporation's incorporation for or on behalf of related persons. (Income from the insurance of related parties' third-country risks is taxed as foreign base company services income.) Foreign base company income also includes foreign base company shipping income, except to the extent such income is reinvested by the controlled foreign corporation in foreign shipping operations. Finally, foreign base company income generally includes "downstream" oil-related income, that is, foreign oil-related income other than extraction income.

Foreign personal holding company income, defined somewhat differently than for subpart F purposes, may also be subject to current U.S. taxation under a different, older set of Code rules, the foreign personal holding company rules (secs. 551–58). Congress enacted the foreign personal holding company rules in 1937 to prevent U.S. taxpayers from accumulating income tax-free in foreign "incorporated pocketbooks." If five or fewer U.S. citizens or resi-

dents own, directly or indirectly, more than half of the outstanding stock (in value) of a foreign corporation that has primarily foreign personal holding company income (generally passive income such as dividends, interest, royalties, and rents (if rental income does not amount to 50 percent of gross income)), that corporation will be a foreign personal holding company. In that case, the foreign corporation's U.S. shareholders, including U.S. citizens, residents, and corporations, are subject to U.S. tax on their pro rata share of the corporation's undistributed foreign personal holding company income. Though only individuals count in the determination of foreign personal holding company status, persons other than individuals may be subject to foreign personal holding company tax.

Reasons for Change

Overview

The committee believes that deferral of U.S. tax on the income of U.S.-owned foreign corporations is generally appropriate until such income is repatriated or the stock of such foreign corporations is sold. However, the committee believes that a 10-percent or greater U.S. shareholder in a U.S.-controlled foreign corporation should not receive the benefits of deferral when a significant purpose of earning income through the foreign corporation is the avoidance of tax. Such a policy serves to limit the role that tax considerations play in the structuring of U.S. persons' operations and investments. Because movable income earned through a foreign corporation could often be earned through a domestic corporation instead, the committee believes that a major motivation of U.S. persons in earning certain kinds of income through foreign corporate vehicles often is the tax benefit expected to be gained thereby. The committee believes that it is generally appropriate to impose current U.S. tax on easily movable income earned through a controlled foreign corporation, since there is likely to be limited economic reason for the U.S. person's use of the foreign corporation. The committee believes that by eliminating the U.S. tax benefits of such transactions, U.S. and foreign investment choices are placed on a more even footing, thus encouraging more efficient (rather than more tax-favored) uses of capital.

The committee believes that the following types of income may sometimes be earned through a foreign corporation in a tax haven country that bears limited substantive economic relation to the income, and that continued deferral of U.S. tax on such income encourages the movement of the income abroad at the U.S. Treasury's expense.

Sales of property which does not generate active income

Foreign personal holding company income that is subject to current U.S. taxation when earned by a controlled foreign corporation includes the excess of gains over losses from sales and exchanges of all stock and securities (except in the case of regular dealers). Thus, U.S. shareholders of a controlled foreign corporation are subject to current taxation not only on the dividends and interest generated by stock and securities, but also on the net gain realized when such investment property is disposed of. However, under

present law passive investment property other than stock and securities is not subject to current tax when disposed of. The committee believes that this inconsistency should be eliminated, and has concluded that a more logical approach is to tax currently net gains on the disposition of other noninventory property which gives rise to passive income (under the foreign personal holding company provisions of subpart F) or is non-income producing. Thus, for example, a controlled foreign corporation's disposition of a patent or license (not used in the active conduct of a trade or business) should be subject to current U.S. taxation to the corporation's U.S. shareholders.

Commodities transactions

Foreign personal holding company income that is subject to current U.S. taxation when earned by a controlled foreign corporation includes the excess of gains over losses from futures transactions in any commodity (with a hedging exception). The committee believes that the limitation of this rule to commodities futures transactions inappropriately excludes from subpart F gains realized by passive investors in commodities contracts other than futures contracts. The committee thus concludes that net income from all commodities transactions should generally be subject to current U.S. taxation under subpart F. However, the committee recognizes that commodities transactions may constitute an integral part of the active business of a producer, processor, merchant, or handler of commodities. Just as many futures transactions of such persons are generally excluded from foreign personal holding company income (under the hedging exception), non-futures transactions of such persons should be excluded from subpart F taxation under a similar rule.

Foreign currency gains

Congress enacted subpart F in 1962 when currency exchange rates generally were fixed. Since the advent of floating exchange rates in the early 1970's, taxpayers have realized foreign currency gains and losses. In connection with its general clarification of the tax rules governing foreign currency exchange rate gains and losses (see F., below), the committee believes that certain currency gains and losses should be subjected to tax under subpart F. The committee believes that income from trading in foreign currencies represents the type of income that can easily be routed through a controlled foreign corporation in a tax haven jurisdiction. Therefore, the excess of foreign currency exchange rate gains over foreign currency exchange rate losses should generally be subject to current U.S. taxation under subpart F, unless directly related to the business needs of the corporation.

Income of non-bona fide banks

Dividends, interest, and gains from sales of stock and securities are under present law generally treated as foreign personal holding company income that is subject to current taxation under subpart F. However, when such income is received from unrelated persons in the conduct of a banking, financing, or similar business it is not subjected to current taxation under subpart F. Existing regulations

(Treas. Reg. sec. 1.954-2(d)(2)(ii)) broadly define a banking, financing, or similar business for purposes of the exception. Some taxpayers invoke the banking exception to avoid current tax on what, in substance, is passive investment income. They route such income through a controlled foreign corporation that nominally conducts a banking business. Under the regulations, a controlled foreign corporation is considered to be engaged in the conduct of a banking, financing, or similar business if it is engaged in business and the activities of that business consist of any one or more of the following activities: receiving deposits of money from the public; making personal, mortgage, industrial, or other loans to the public; purchasing, selling, discounting, or negotiating for the public on a regular basis notes, drafts, checks, bills of exchange, acceptances, or other evidences of indebtedness; issuing letters of credit to the public and negotiating drafts drawn thereunder; providing trust services for the public; financing foreign exchange transactions for the public; purchasing stock, debt obligations, or other securities from an issuer or holder with a view to the public distribution thereof; or offering or selling stock, debt obligations, or other securities for an issuer or holder in connection with the public distribution thereof.

A problem with the current regulations is that they do not require that the foregoing activities constitute any particular proportion of a foreign corporation's activities in order for the corporation to be considered engaged in the conduct of a banking, financing, or similar business. The regulations state that securities income will qualify for the banking exception only if the securities are acquired as an ordinary and necessary incident to the conduct of a banking, financing, or similar business, but this limitation, in practice, is very difficult to enforce. The proliferation in various tax haven jurisdictions of U.S.-controlled entities that carry on nominal banking activities suggests that many taxpayers are in fact attempting to take advantage of the banking exception, as presently interpreted, to earn interest, dividends, and gains free of current U.S. tax and, frequently, free of significant foreign tax.

The committee believes that the availability of the banking exception to current tax should be limited to controlled foreign corporations, a substantial portion of the activities of which do *not* consist of activities other than bona fide banking, financing, or similar activities. Thus, dividends, interest, and gains from the disposition of stock or securities should be treated as foreign personal holding company income subject to current U.S. taxation under subpart F when the corporation receiving such income is only involved on a limited basis in a banking, financing, or similar business and is not eligible for any other exception to the current taxation rules.

Related person exceptions

Foreign personal holding company income presently does not include dividends and interest received from a related person organized and operating in the same foreign country as the recipient, interest paid between related persons engaged in the conduct of a banking, financing, or similar business, or rents and royalties received from a related person for the use of property within the

country in which the recipient was created or organized. Thus, for example, interest paid by a sales subsidiary to a holding company organized in the same foreign country generally would not be treated as foreign personal holding company income subject to current tax under subpart F.

The exceptions for interest, rent, and royalty payments can be manipulated to avoid current U.S. taxation of tax haven income. For example, if one company in a group earns subpart F income, but pays interest to a related company in the same foreign country, the deduction for the interest paid to the related company can reduce the first company's subpart F income while, at the same time, the interest is not considered tax haven income to the second company because of the same country interest exception. Thus, intercompany payments that benefit from the same country exceptions can reduce the total subpart F income of a group of related companies. The committee therefore concludes that the above exceptions should be limited by a rule that looks through to the nature of the income earned by the payor.

In addition, the committee wishes to limit the availability of the related party banking exception to bona fide, active banks, finance companies, and similar businesses, consistent with the restriction to bona fide banks, etc., of the general exception for dividends, interest, and gains from sales of stock and securities derived from unrelated persons in a banking, financing, or similar business.

Explanation of Provisions

Overview

The bill narrows certain of the exceptions to subpart F income and adds to it certain other types of income that are particularly susceptible of manipulation. Thus, net gains on sales of property which does not generate active income, net commodities gains, and net foreign currency exchange rate gains are added to subpart F foreign personal holding company income. In addition, the bill limits the availability of the present law exception for banking income from interest, dividends, and dispositions of stock and securities to bona fide, active banking, financing, or similar operations. The same restriction is applied to the present law exception for interest paid between related banks. The general exception for certain payments between related persons is subjected to a new look-through rule that takes into account the subpart F income of related party payors.

Sales of property which does not generate active income

The bill adds to the Code section 954(c) definition of foreign personal holding company income for subpart F purposes the excess of gains over losses from sales and exchanges of non-income producing property and property that gives rise to the following types of passive (foreign personal holding company) income: first, dividends and interest other than those excluded from subpart F under the active business exception for banks (as modified by the bill) or the active business exception for insurance companies; second, rents and royalties other than active business, unrelated party rents and royalties; and, third, annuities. Thus, included in foreign personal

holding company would be, for example, gain on the sale of diamonds held for investment purposes prior to disposition. As another example, gain from the disposition of a patent that gave rise to unrelated party, active business royalties would not be treated as foreign personal holding company income under this rule while gain from the sale of a patent licensed to a person related to the seller would be so treated.

The committee retains the present law exception from the current taxation rules for securities gains of regular dealers and extends that exception to the broader category of gains just described. Thus, for example, the gain of a regular art dealer on the sale of a painting would not constitute subpart F foreign personal holding company income. On the other hand, the gain of a company on the sale of a painting held as an investment property generally would be subpart F foreign personal holding company income (at least before application of subpart F's de minimis exception): if, prior to its disposition, the painting merely was displayed in the corporate offices or held in storage, it would not have given rise to any income; if, prior to its disposition, the painting was leased temporarily by the corporation for compensation, such compensation would not have been active rental income of the type excluded from foreign personal holding company income. Gains from the sale or exchange of other property which, in the hands of the seller, is inventory property (Code sec. 1221(1)) also are excluded from the application of the new rule.

The committee retains the present law subpart F treatment of gains on sales of stock and securities. Thus, gain on the sale of stock in, for example, a foreign corporation, whether or not created or organized in the same foreign country as the selling company, constitutes foreign personal holding company income under subpart F.

Commodities transactions

The bill adds to the section 954(c) definition of foreign personal holding company income for subpart F purposes the excess of gains over losses from transactions (including futures transactions) in any commodities. The bill retains the present law exception for gains by a producer, processor, merchant or handler of a commodity which arise from bona fide hedging transactions reasonably necessary to the conduct of its business in the manner in which such business is customarily and usually conducted by others.

An additional exception is provided for transactions (not limited to hedging transactions) that occur in the active business of a foreign corporation substantially all of whose business is that of an active producer, processor, merchant, or handler of commodities. The committee intends this exception to apply only to foreign corporations actively engaged in commodities businesses, not those primarily engaged in such financial transactions as the trading of futures. Regularly taking delivery of physical commodities will generally indicate the existence of such a business, but such activity will not of itself determine the issue. For example, the business of a company that trades primarily in precious metals may be essentially financial, particularly if the company takes delivery of the metals through an agent such as a bank. (The availability, if any,

of the present law hedging exception with respect to such a business is not affected by the bill.)

Other characteristics of companies actively engaged in commodities businesses include: engaging in substantial processing activities and incurring substantial expenses with respect to commodities prior to their sale, including (but not limited to) concentrating, refining, mixing, crushing, aerating, and milling; engaging in significant activities and incurring substantial expenses relating to the physical movement, handling, and storage of commodities, including (but not limited to) preparation of contracts and invoices, arrangement of freight, insurance, or credit, arrangement for receipt, transfer, or negotiation of shipping documents, arrangement of storage or warehousing, and dealing with quality claims; owning and operating physical facilities used in the activities just described; owning or chartering vessels or vehicles for the transportation of commodities; and producing the commodities sold.

Foreign currency gains

The bill adds to the section 954(c) definition of foreign personal holding company income for subpart F purposes the excess of foreign currency gains over foreign currency losses attributable to section 988 transactions. An exception to current taxation is provided for hedging and other transactions that are directly related to the business needs of a controlled foreign corporation. Foreign currency gains and losses attributable to section 988 transactions are defined as they are for purposes of the bill's new rules relating to the taxation of foreign currency exchange rate gains and losses (sec. 961 of the bill, see F., below).

Income of non-bona fide banks

The bill limits the application of the present law rule excluding from foreign personal holding company income for subpart F purposes dividends, interest, and gains from the sale or exchange of stock or securities received from unrelated persons in the conduct of a banking, financing, or similar business to bona fide, active banking, financing and similar operations (sec. 954(c)(3)(B)). Similarly, under the bill, the rule presently excluding from foreign personal holding company income for subpart F purposes interest paid by a related person to a controlled foreign corporation if both are engaged in a banking, financing or similar business applies only if both payor and payee are engaged in bona fide, active banking, financing, or similar operations (section 954(c)(4)(B)).

Under the bill, an entity is considered to be engaged in the conduct of a bona fide, active banking, financing, or similar business for purposes of these subpart F exceptions (and for purposes of the separate foreign tax credit limitation for passive income established by the bill) only if it regularly and continuously conducts with unrelated persons at least one or more of the following activities: (1) receiving deposits of money from the public; (2) making personal, mortgage, industrial, or other loans to the public; or (3) either purchasing stock, debt obligations, or other securities from an issuer or holder for public distribution thereof, or offering or selling stock, debt obligations, or other securities for an issuer or holder in connection with the public distribution thereof, or partici-

pating in any such undertaking. The bill provides an anti-abuse rule in connection with the preceding definition: under the bill, an entity will not be treated as conducting a bona fide, active banking, financing, or similar business if a substantial portion of the entity's activities are activities other than those enumerated above. The bill requires the IRS to prescribe such regulations as may be necessary or appropriate to carry out the purposes of the new bona fide bank limitation, including regulations setting forth safe harbor rules for the application of the anti-abuse rule.

For purposes of the bona fide bank definition, loans to the public include those loans originated by the entity in question only. These are loans for which the entity performs a credit check and the terms of which the entity actively negotiates. Obligations originated by other entities, related or unrelated, are not to be treated as loans to the public. Thus, for example, obligations acquired from third parties will not qualify as loans to the public. Purchasing bonds, such as Eurobonds, from underwriters, issuers, or secondary market sellers will not constitute the origination of loans for purposes of the bona fide banking definition.

Under the anti-abuse rule, a bona fide bank does not include, for example, a controlled foreign corporation a substantial portion of the assets of which are not loans to the public and a substantial portion of the liabilities of which are other than deposits from the public. A bona fide bank would include, however, a controlled foreign corporation the assets of which consist chiefly of loans to the public.

An underwriter will be considered a bona fide, active banking, financing, or similar business under the bill if, for example, its activities consist primarily of selling debt obligations for an issuer in connection with the public distribution thereof. A broker will qualify if it is principally engaged in, for example, purchasing stock or other securities from an issuer or holder with a view to public distribution thereof.

Related person exceptions

The bill restricts the present law rule that excludes from foreign personal holding company income for subpart F purposes certain dividends, interest, rents, and royalties received from related persons (section 954(c)(4) (A), (B), and (C)). (The scope of section 954(c)(4)(B), relating to interest paid between related banks, is also modified by the bill. See discussion of non-bona fide banking income, above.) Under the new restriction, interest, rent, and royalty payments will not qualify for the exclusion to the extent that such payments reduce subpart F income of the payor. Thus, if the income of the payor corporation consists entirely of non-subpart F income, then the related party exclusions of section 954(c)(4) (A), (B), and (C) will apply in full as under present law. However, to the extent that the payor corporation receives subpart F income which is reduced by its payment of interest, rent, or royalties, then such payment will be treated as subpart F income to a related party recipient, notwithstanding the general rules of section 954(c)(4).

As an example, assume that a controlled foreign corporation receives from a related party a $100 interest payment that, under present law, would be excluded from foreign personal holding com-

pany income for subpart F purposes under section 954(c)(4) (A) or (B). The payee corporation also earns foreign base company services income taxable currently to its shareholders under subpart F. Assume that none of the expenses incurred by the payee are allocable to the $100 of interest in determining the payee's net income subject to subpart F taxation. The related party payor of the interest, also a controlled foreign corporation, earns $5,000 of gross manufacturing income that is not subject to tax under subpart F and $500 of gross portfolio dividends that *are* subject to tax under subpart F. The payor uses the asset method to allocate its $100 of interest expense for purposes of determining the amount of its subpart F income. Under the asset method, $90 of the interest is allocable to the payor's gross manufacturing income and the remaining $10 reduces the payor's gross portfolio dividends subject to subpart F. Therefore, $10 of the $100 of interest received by the payee will be treated as subpart F income of the payee's U.S. shareholders. The look-through rule will operate in the same manner in this example if the $100 payment is a rent, royalty, or similar amount (otherwise excluded from subpart F taxation under section 954(c)(4)(C)) rather than interest.

The bill also provides a limited exclusion from subpart F foreign personal holding company income for certain mining-related income.

Effective Date

In general, the above changes apply for taxable years of foreign corporations beginning after December 31, 1986.

The limited exclusion from subpart F for certain mining-related income is effective for dividends received after December 31, 1986.

Revenue Effect

These provisions are estimated to increase fiscal year budget receipts by $25 million in 1987, $41 million in 1988, $41 million in 1989, $44 million in 1990, and $49 million in 1991.

2. Thresholds for Imposition of Current Tax Under Subpart F

a. Determination of U.S. control of foreign corporation (sec. 922 of the bill and secs. 552 and 957 of the Code)

Present Law

The provisions of subpart F (Code secs. 951–64), which impose current tax on foreign corporate earnings, apply only to controlled foreign corporations. A corporation is a controlled foreign corporation only if more than 50 percent of the voting power of the corporation belongs to U.S. persons that each own at least 10 percent of that voting power. Similarly, the foreign personal holding company rules (Code secs. 551–58), which also impose current U.S. tax on some foreign corporate investment income, apply only if more than 50 percent of the value (as opposed to voting power) of the corporation belongs to five or fewer U.S. individuals.

Reasons for Change

The committee is concerned that the present controlled foreign corporation rules can be manipulated by taxpayers to avoid the provisions of subpart F. Since U.S. control is defined solely in terms of voting power, taxpayers can structure their investments to avoid subpart F by ensuring that they hold no more than 50 percent of the voting power of a corporation, even when they hold the majority of the value of the corporation in the form of nonvoting stock. The committee notes that Congress amended the consolidated return rules in 1984 to consider both vote and value because of a similar concern that taxpayers could manipulate a single factor test. Also, Congress mandated vote or value tests for the provisions of the 1984 Act that maintain the character and source of income earned by U.S.-owned foreign corporations and those that extend application of the accumulated earnings tax to U.S.-owned foreign corporations.

The committee believes that the foreign personal holding company rules are similarly subject to manipulation, since they rely on a single-factor (value) greater-than-50 percent test.

Explanation of Provision

The bill amends the definition of a controlled foreign corporation (Code section 957(a)) to provide that subpart F will apply to the U.S. shareholders of a foreign corporation if more than 50 percent of either the voting power or the value of the stock of the corporation is owned by U.S. persons that each own at least 10 percent of the vote on any day during the taxable year of the foreign corporation. Similarly, the foreign personal holding company rules will apply if more than 50 percent of either the voting power or the value of a foreign corporation belongs to five or fewer U.S. individuals.

Effective Date

The provision generally applies to taxable years of foreign corporations beginning after December 31, 1986. However, deficits in earnings and profits for taxable years beginning before 1987, and, for purposes of Code section 956, property acquired before 1987, will not be taken into account with respect to corporations that become subject to subpart F because of this provision.

In the case of an individual who is a beneficiary of a trust and who was not a U.S. resident on the date such trust was established, any amounts included by reason of this provision in the gross income of the individual with respect to stock held by the trust (and treated as distributed by the trust) are to be treated as the first amounts distributed by the trust to the individual and as previously taxed income (under Code sec. 959(a)).

Revenue Effect

The provision is expected to increase fiscal year budget receipts by less than $5 million annually.

b. Definition of related person (sec. 921 of the bill and sec. 954 of the Code)

Present Law

Whether a controlled foreign corporation's income is subject to subpart F will depend in certain cases on whether the income is received from a related person. In general, a related person for purposes of subpart F is defined (in Code sec. 954(d)(3)) as an individual, partnership, trust, or estate which controls the foreign corporation, a corporation which controls or is controlled by the foreign corporation, or a corporation which is controlled by the same persons that control the foreign corporation. Thus, a partnership, trust, or estate in which the controlled foreign corporation holds an interest is not considered a related person under this definition.

For purposes of the above rules, control of a corporation is defined as the direct or indirect ownership of stock possessing more than 50 percent of the total combined voting power of all classes of stock entitled to vote.

Reasons for Change

The committee believes that the exclusion of a controlled partnership, trust, or estate from the subpart F definition of a related person is without logical support. Income that would be treated as subpart F income of a controlled foreign corporation if received from a subsidiary corporation can avoid such treatment simply by being routed through a controlled partnership instead.

In addition, the committee is concerned that defining control of a corporation solely in terms of voting power makes it relatively easy to avoid related person status, and thus possibly to avoid subpart F. This is so because related person status with respect to any given corporation can be avoided without giving control of the corporation to other persons, by structuring an investment in that corporation so that no more than 50 percent of the voting power is held, even though the holder may own a majority of the value of the corporation in the form of nonvoting stock.

Explanation of Provision

The bill expands the definition of related person in Code section 954(d)(3) to include a partnership, trust, or estate which controls, or is controlled by, the foreign corporation, as well as a partnership, trust, or estate which is controlled by the same persons that control the foreign corporation.

In addition, the bill amends the definition of control for this purpose. In the case of a corporation, control means the direct or indirect ownership of 50 percent or more of the total combined voting power of all classes of stock entitled to vote or of the total value of such corporation. In the case of a partnership, trust, or estate, control is defined as direct or indirect ownership of 50 percent or more of the total value of the beneficial interests in the entity.

Effective Date

The provision applies to taxable years of foreign corporations beginning after December 31, 1986.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by less than $5 million per year.

c. De minimis tax haven income rule (sec. 923 of the bill and sec. 954 of the Code)

Present Law

The subpart F rules that impose current U.S. tax on income of controlled foreign corporations apply only to certain types of income. One major category of income that is subject to current taxation under subpart F is foreign base company income. Foreign base company income includes passive investment income and certain sales, services, shipping, and oil related income. A de minimis rule in subpart F provides that if less than 10 percent of a foreign corporation's gross income is base company income, then none of the income will be treated as base company income. On the other hand, if more than 70 percent of a foreign corporation's gross income is base company income, then all of its income will be treated as base company income.

Reasons for Change

The committee is concerned that the 10-percent de minimis rule allows taxpayers to earn substantial amounts of tax haven income (such as interest) free of current tax under subpart F. The committee believes that the 10-percent de minimis threshold for subpart F taxation of tax haven income should be reduced; a corporation should not be excepted from subpart F when a substantial amount of its income is tax haven income.

Explanation of Provision

Under the bill, if less than 5 percent of a controlled foreign corporation's gross income is foreign base company income, then none of its income will be treated as base company income. As under present law, if more than 70 percent of a controlled foreign corporation's gross income is base company income, then all of its income will be treated as such.

Effective Date

The provision applies to taxable years of foreign corporations beginning after December 31, 1986.

Revenue Effect

The provision is expected to increase fiscal year budget receipts by $12 million in 1987, $22 million in 1988, $24 million in 1989, $26 million in 1990, and $29 million in 1991.

d. Possessions corporations (sec. 924 of the bill and sec. 957 of the Code)

Present Law

A corporation chartered in the possessions is not considered a controlled foreign corporation if (1) at least 80 percent of the corporation's gross income is from sources within a possession, and (2) at least 50 percent of the corporation's gross income is from the active conduct of a manufacturing, processing, fishing, mining, or hotel business. Thus, the tax-haven type (subpart F) income of such corporations is not taxed currently to controlling U.S. shareholders. This provision was enacted in 1962 in conjunction with the enactment of subpart F, and was intended to promote investments in active businesses in the possessions.

Reasons for Change

The committee believes that the exemption from controlled foreign corporation status available to possession-chartered corporations is poorly targeted to the creation of employment-producing investments in the possessions. The exemption of tax haven income from current taxation under subpart F would not appear to provide incentive for the type of substantial economic activity that is needed to promote employment and economic development in the possessions.

Explanation of Provision

The exemption from controlled foreign corporation status available to possession-chartered corporations is repealed. Thus, U.S. shareholders of possessions corporations will be treated like U.S. shareholders of other foreign corporations, so they will be subject to current U.S. tax under subpart F on tax haven-type income of the corporations.

Effective Date

The provision generally applies to taxable years of foreign corporations beginning after December 31, 1986. However, deficits in earnings and profits for taxable years beginning before 1987, and, for purposes of Code section 956, property acquired before 1987, will not be taken into account with respect to corporations that become subject to subpart F because of this provision.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by less than $5 million per year.

3. Deduction for Dividends Received from Foreign Corporations (secs. 987 of the bill and secs. 245 and 904 of the Code)

Present Law

Under present law, corporations that receive dividends generally are entitled to a deduction equal to 85 percent of the dividends received (sec. 243(a)(1)). Dividends received by a U.S. corporation from

a foreign corporation generally are not eligible for the dividends received deduction, even though the foreign corporation may have paid U.S. income tax. However, a portion of the dividends paid by such corporation to a U.S. corporate shareholder is eligible for the dividends received deduction where at least 50 percent of a foreign corporation's gross income is effectively connected with a U.S. trade or business during an uninterrupted period of 36 months ending with the close of the year in which the dividends are paid (or for the period of the corporation's existence, if shorter). That portion generally is based on the percentage of the foreign corporation's gross income that is effectively connected with its U.S. trade or business (sec. 245). Where a foreign corporation is wholly owned by a U.S. corporation and all of its income is effectively connected with a U.S. trade or business, dividends paid by such corporation generally are eligible for a 100 percent dividends received deduction.

If a U.S. corporation is eligible to claim a deduction for dividends received from a foreign corporation, the U.S. recipient must treat for foreign tax credit purposes as U.S. source income the amount of the dividend attributable to U.S. effectively connected income of the foreign corporation (sec. 861(a)(2)(B)). The Tax Reform Act of 1984 similarly provided rules that convert what would otherwise be foreign source income into U.S. source income if paid by certain entities. In the case of dividends paid by a foreign corporation, these rules apply if the foreign corporation is beneficially owned 50 percent or more by U.S. persons and earns income from U.S. sources. In such cases, dividends paid are treated as U.S. source to the extent the dividends are attributable to U.S. source earnings of the corporation.

Reasons for Change

The committee recognizes that in a two-tiered tax system such as in the United States, double taxation will occur (one tax at the corporate level and a second tax at the individual level at the time of distributions). The dividends received deduction is intended to prevent more than one full corporate level tax on the same earnings. The committee recognizes that present law's deduction for dividends received from foreign corporations achieves the deduction's purpose in the case of a U.S. corporate shareholder of a foreign corporation with a U.S. branch that engages in a U.S. trade or business, wnere the income from that trade or business meets the 50 percent threshold. The committee is concerned, however, that the purpose of the deduction is not achieved in other circumstances and believes that modifications to present law are warranted.

Under present law, if earnings of a domestic corporation, owned by a foreign corporation which is in turn owned by a domestic corporation, are remitted to the ultimate owners, the United States will subject the same earnings to more than one corporate level tax. The committee does not believe this result reflects the purpose of the dividends received deduction. The committee also notes that the effect of present law is to favor a branch operation over a subsidiary operation since earnings paid by a U.S. subsidiary to a foreign parent not engaged in a U.S. trade or business are not eligible

for the dividends received deduction when distributed to the foreign corporation's U.S. shareholders. The committee does not believe this preferential treatment is appropriate. For administrative reasons and to approximate the policy of the indirect foreign tax credit (which attempts to treat foreign taxes paid by subsidiaries similar to foreign taxes paid by branches) the committee believes, however, that it is appropriate to restrict the availability of the deduction to those U.S. shareholders who own a substantial portion of the foreign corporation's shares. These shareholders will be able to receive the necessary information to determine what portion of dividends are attributable to U.S. earnings of the foreign corporation (and would be eligible to claim an indirect credit for foreign taxes paid by the foreign corporation).

Present law also results in an inappropriate benefit. Assume, for example, a foreign corporation that earns $100 gross income effectively connected with its U.S. trade or business and earns $100 of foreign source gross income. Because present law's deduction is based on the ratio of U.S. gross income to total gross income, U.S. shareholders of the corporation are able to exclude 50 percent of any dividends (subject to the percentage limitation) received from the corporation without regard to the expenses associated with the income. If the corporation incurred $100 or more of expenses to generate the effectively connected income, the dividends received deduction would still be available even though there are no U.S. earnings available for distribution. The committee does not believe this result is appropriate and believes the availability of the deduction should be based on net earnings of the corporation.

Because dividends from foreign corporations are generally treated as foreign source, the committee recognizes that an allowance for a dividends received deduction without any change to the source rules may provide a double benefit to U.S. persons. If a U.S. person is able to treat as foreign source any part of the dividend attributable to U.S. earnings (and which is not offset by the dividends received deduction), the taxpayer may be able to offset the U.S. tax on such portion with excess foreign tax credits from other operations. The United States will, therefore, relinquish tax on income that it otherwise would collect on dividends paid by U.S. corporations. The committee does not believe this potential additional benefit is appropriate. Moreover, the committee recognizes that to treat U.S. source income as foreign source income merely because it passes through an intervening foreign corporation circumvents the purpose of the foreign tax credit limitation.

Explanation of Provision

Dividends received deduction

Under the bill, the deduction for dividends received from foreign corporations is modified in two respects. First, the deduction is eligible only to U.S. corporations that own at least 10 percent of the voting stock of a foreign corporation. Second, the deduction is allowed if the foreign corporate payor operates a U.S. branch that earns any amount of income effectively connected with the conduct of a U.S. trade or business or owns a U.S. subsidiary from which it receives dividends. Thus, the bill eliminates the preferential treat-

ment of branches over subsidiaries. The bill also provides that the deduction is available if the dividends from the U.S. corporation are paid through a second wholly-owned foreign corporation before they are remitted to the ultimate U.S. corporate shareholder. The bill defines U.S. subsidiary as a corporation at least 80 percent of the total voting power and value of which is held by a foreign corporation.

The amount of the deduction is based on the general rules applicable to dividends from U.S. corporations. Section 611 of the bill reduces the present law percentage deduction for certain dividends received from 85 percent to 80 percent.

The bill provides that the U.S. recipient can only claim a deduction for the dividends attributable to earnings of the foreign corporation that have been subject to U.S. tax, based on the ratio of earnings and profits from U.S. sources (the sum of net income effectively connected with a U.S. trade or business and dividends (less allocable expenses) from U.S. subsidiaries) to entire earnings and profits of the foreign corporation for the current year.

The bill provides that the "pooling" rules adopted by the committee for Code section 902 (sec. 904 of the bill) apply to a foreign corporation's accumulated earnings and profits that are attributable to U.S. sources. Therefore, in addition to the pools required for separate foreign tax credit limitations, the foreign corporation must maintain a separate pool for earnings attributable to U.S. sources. Moreover, the committee intends that foreign taxes imposed on U.S. source earnings of the foreign corporation be attributed to income allocated to the overall limitation for purposes of section 904.

The bill provides corresponding changes to present law in the case of a foreign corporation wholly owned by a U.S. corporation. In such cases, if the income of the foreign corporation is entirely attributable to income effectively connected with a U.S. trade or business or to dividends received from a U.S. subsidiary, the U.S. recipient is eligible to exclude the entire dividend from its income.

Source of dividends eligible for deduction

The bill provides that for foreign tax credit purposes, if otherwise treated as foreign source under the Code's general source rules, the entire amount of the dividend eligible for the deduction is to be treated as U.S. source. As provided by the Tax Reform Act of 1984, this special sourcing rule applies even when the dividends are paid through more than one foreign corporation. If the foreign corporation operates a U.S. trade or business through a branch, and such business generates income to the corporation that constitutes at least 10 percent of the corporation's total gross income, dividends paid by the corporation are currently subject to the general source rules of the Code (as provided by sec. 651 of the bill). In such instances, a pro rata portion of the dividends are U.S. source. The bill's provision above operates only to the extent the dividends are not already treated as U.S. source under general rules of the Code. If the current rules create a greater amount of U.S. source income, such provisions will control. Otherwise, the bill's provision controls.

The bill's provisions can be illustrated by the following example. Assume a U.S. subsidiary remits a $100 dividend to its foreign cor-

porate shareholder, such shareholder has $900 of non-effectively connected net income, and the foreign corporation remits a $100 dividend to its 10-percent-owned U.S. corporate shareholder. Under the bill, the U.S. recipient is eligible for a dividends received deduction of $8 (100/1000 x 100 x .80) and has gross U.S. source income of $10 (100/1000 x 100). Assuming the same facts above, if a wholly-owned foreign corporation is interposed between the U.S. subsidiary and the foreign corporate payor, such interposed corporation has $400 of non-effectively connected net income in addition to the $100 dividend, and such corporation remits $100 to its parent, the U.S. recipient would be eligible for a deduction of $1.60 and would have gross U.S. source income of $2.

Effective Date

The provisions are effective for dividends received in taxable years beginning after December 31, 1986.

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by less than $5 million annually.

D. Special Tax Provisions for U.S. Persons

1. Modifications to Possession Tax Credit (Sec. 941 of the bill and secs. 934 and 936 of the Code)

Present Law

Law prior to 1976

Special provisions for the taxation of possession source income were first enacted in the Revenue Act of 1921. These provisions were adopted primarily to help U.S. corporations compete with foreign firms in the Philippines (then a U.S. possession), although in recent years most of the tax benefit is claimed by corporations located in Puerto Rico. Under the 1921 Act, qualified corporations deriving 80 percent or more of their income from U.S. possessions were exempted from income tax on their foreign source income. To qualify for the exemption, at least 50 percent of the corporation's income had to be derived from the conduct of an active trade or business (as opposed to passive investment income). Dividends paid to a U.S. parent from a qualified possession subsidiary were taxable, while liquidating distributions were tax-exempt. Since the Puerto Rican Industrial Incentives Act of 1948, most possessions subsidiaries have operated under a complete or partial exemption from Puerto Rican taxes. Thus, a U.S. subsidiary doing business in Puerto Rico could avoid both Federal and local tax by accumulating operating income until its grant of local exemption expired, and then liquidating into the mainland parent.

Tax Reform Act of 1976

Although the Philippines ceased to be a U.S. possession in 1946, the special tax treatment of possessions corporations remained unchanged until the Tax Reform Act of 1976.[2] In 1976, Congress indicated that Federal tax exemption had played an important role in Puerto Rican economic development. In the Finance Committee Report accompanying the 1976 Act,[3] the purpose of the special tax treatment of possession-source income was said to be "[to] assist the U.S. possessions in obtaining employment producing investment by U.S. corporations". The need for special tax incentives was attributed, in part, to the additional costs imposed by possessions status, such as the U.S. minimum wage standards and the requirement to use U.S. flag ships.

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[2] In 1954, these provisions were incorporated in sec. 931 of the Internal Revenue Code. Presently, the special tax rules apply to Puerto Rico, Guam, American Samoa, and the territories of Wake, Midway, and the Commonwealth of the Northern Mariana Islands. Separate, but similar, tax treatment applies to the U.S. Virgin Islands.

[3] Report of the Committee on Finance, United States Senate, on H.R. 10612, Sen. Rpt. 94-938 (June 10, 1976), p. 279.

It appeared that several features of the possession tax system had a high revenue cost with little corresponding benefit to employment or investment in the possessions. To avoid U.S. tax on dividends paid to a mainland parent, possession subsidiaries invested accumulated earnings from operations in foreign countries, either directly or through the Puerto Rican banking system. Thus, the benefits of the possession tax exemption were not limited to investments in the possessions.[4]

The 1976 Act added section 936 to the Internal Revenue Code, which altered the taxation of U.S. chartered possessions corporations. To more closely conform the tax treatment of possession income with the taxation of foreign source income, the exemption was converted to a credit. Thus, possession-source income was included in the definition of the possessions corporation's worldwide income. However, in lieu of the ordinary foreign tax credit (for income taxes paid to foreign governments) a tax credit was enacted (the possession tax credit) for the full amount of U.S. tax liability on possessions source income. This is referred to as "tax sparing" since a credit is granted whether or not foreign taxes are paid. Dividends repatriated from a possessions corporation qualify for the dividend-received deduction, which allows tax-free repatriation of possessions income.[5]

The 1976 Act defined qualified possession-source investment income ("QPSII") to include only income attributable to the investment of funds derived from the conduct of an active trade or business in the possessions. The intent was to provide tax benefits to investment income only when this income resulted from an active investment in the possessions. Income from investments in financial intermediaries, such as possession banks, was made eligible for the credit only if it could be shown that the intermediary reinvested the funds within the possession.

Tax Equity and Fiscal Responsibility Act of 1982

Despite the provisions in the 1976 Act, Congress in 1982 was concerned that the possession tax credit was costly and inefficient. According to the Finance Committee Report on the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA):[6] "Treasury's three reports to date have confirmed the existence of two problems in that system: (1) unduly high revenue loss attributable to certain industries due to positions taken by certain taxpayers with respect to the allocations of intangible income among related parties, and (2) continued tax exemption of increased possession source investment income."

In addition, there was considerable disagreement under prior law regarding the extent to which intangible assets could be transferred to a possessions corporation free of U.S. tax. In July of 1980, the Internal Revenue Service issued Technical Advice Memorandum 8040019 which stated that intangibles transferred to a possession subsidiary at less than a reasonable arm's-length price did

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[4] U.S. General Accounting Office, *Puerto Rico's Political Future: A Divisive Issue with Many Dimensions*, (March 2, 1981), GGD-81-48, p. 69.

[5] Dividends paid by a section 936 corporation qualify for a 100-percent dividends received deduction (sec. 243(a)(a)(C)).

[6] Sen. Rept. No. 97-494, (July 12, 1982). pp. 81-2.

not belong to the subsidiary, and the income derived therefrom was allocable to the parent corporation rather than the subsidiary.

The 1982 Act addressed these issues by (1) increasing the active possession business income percentage requirement for possessions corporation status from 50 to 65 percent of gross income and (2) denying the credit on intangible income of the possessions corporation. However, possessions corporations are permitted to derive some intangible income tax-free if they elect one of two optional methods of computing taxable income: (1) a cost sharing rule and (2) a 50/50 profit split. Under the former option, a possessions corporation is permitted to claim a return on manufacturing (but not marketing) intangibles in computing its income from products it produces, provided that it makes a (taxable) cost-sharing payment to its affiliates. The payment represents the possessions corporation's share of its affiliated group's worldwide direct and indirect research and development (R&D) expenditures in each product area in which the possessions corporation manufactures products subject to the cost sharing election. The possessions corporation's share of R&D expense is determined by reference to the ratio of third-party sales by members of its affiliated group of those products within a given product area, which are produced in whole or in part by the possessions corporation to, such sales of all products within that product area. The cost sharing payment effectively increases the taxable income of the possessions corporation's mainland affiliate and, consequently, its tax liability.

Under the 50/50 profit split election, the possessions corporation's taxable income (eligible for the credit) with respect to any product it produces in whole or in part is equal to 50 percent of the combined taxable income of the domestic members of its affiliated group with respect to covered sales of such product. The combined taxable income associated with a product is determined as the excess of gross receipts (on sales of the product to third parties) over the direct and indirect costs of producing and marketing the product. Thus, to the the extent that combined taxable income represents a return on intangible assets (both manufacturing and marketing intangibles), half of this intangible income is eligible for section 936 tax benefits. For purposes of computing the combined taxable income of which 50 percent is allocated to the possessions corporation, the amount of the group's R&D expenses allocated to income from the sale of a product generally cannot be less than a certain stated percentage of the cost-sharing payment that would have been required under the cost-sharing option.

To derive intangible income on a tax-free basis, the possessions corporation must make an irrevocable election to use one of the two options. A single option must be selected for all products within a product area.[7] in addition, neither option may be used for a product which does not meet the significant business presence test. A product satisfies this test if either (1) at least 25 percent of the value added to the product is a result of economic activity in the possessions, or (2) at least 65 percent of the direct labor cost for the product is incurred in the possessions. Finally, TEFRA general-

[7] Export sales within a product group are exempt from this requirement.

ly prohibited possessions corporations from making future tax-free transfers of intangibles to foreign corporations.

Reasons for Change

The committee recognizes the importance of the possession tax credit to the possessions generally, and to Puerto Rico in particular. The committee believes that the credit and complementary local tax incentives have been a major factor in helping the economies of the possessions to grow. In addition, the committee understands that the Government of Puerto Rico is developing a "twin-plant" program to encourage companies with operations in Puerto Rico to develop or expand manufacturing operations in qualified Caribbean Basin Initiative ("CBI") countries. As a result of the twin-plant program, the committee anticipates that the continuation of the possession tax credit will promote economic development both in the possessions and in qualified CBI countries. The bill retains the possession tax credit in a form substantially similar to present law, with several modifications designed to encourage more employment-producing investment per dollar of revenue loss to the Treasury. Also, the bill drops certain restrictions on the use of funds giving rise to qualified possession source investment income ("QPSII") to allow the Government of Puerto Rico to implement its initiative to promote economic development in CBI countries.

The committee believes that some modifications are needed in order to make the credit work more efficiently and achieve its objective. Preliminary 1983 data indicate that the changes to the possession tax credit in 1982 reduced the amount of credits claimed by less than was anticipated in the revenue estimates accompanying TEFRA. This discrepancy appears primarily to be attributable to the operation of the cost sharing election. Problems with the cost sharing method may arise in situations where, for example, (1) possessions products fall outside the U.S. affiliates' main area of research or (2) the possessions corporation utilizes the U.S. affiliates' most valuable intangibles. In response to these concerns, the committee bill increases the amount of cost sharing payments required under present law by 10 percent, and makes a corresponding adjustment to the profit split method.

A significant portion of the possession tax credit is attributable to income generated from passive investments. Under present law, qualified possession source investment income may contribute up to 35 percent of the income of a possessions corporation eligible for the possession credit. As a result of this provision, and exemption from Puerto Rican tax, deposits of possessions corporations constitute over one-third of the commercial bank liabilities in Puerto Rico.[8] Investment income is qualified for the credit only if it is derived from funds reinvested in the possessions for use therein. However, the Puerto Rican authorities have been concerned that these funds are being invested outside Puerto Rico (primarily in the Eurodollar market). The Puerto Rican Treasury Department

[8] Under the Puerto Rican Industrial Incentives Act of 1978, income derived from a business operating under a tax-exemption grant may be reinvested free of Puerto Rican tax in certain assets, including term deposits in qualifying Puerto Rican banks.

issued regulations in 1980 and in 1984 that seek to prevent these funds from flowing out of Puerto Rico, but it remains unclear the extent to which these deposits have increased physical investment in Puerto Rico.

The committee believes that requiring possessions corporations to derive a larger fraction of their income directly from the conduct of an active trade or business will better achieve the objectives of creating employment-producing investment in the possessions. Moreover, the committee does not believe, in view of the volume caps on industrial development bonds adopted in the Tax Reform Act of 1984, that it is appropriate for the possessions to be able, in effect, to issue unlimited private purpose tax exempt bonds to U.S. investors.

Under present law, the possession tax credit is denied for otherwise eligible income if receipt occurs in the United States. The bill deletes the U.S.-receipt rule for active business income derived from unrelated parties because in certain situations where payment must be received in the United States (e.g., certain defense contracts), the rule may discourage production in the possessions.

Explanation of Provision

The bill retains the possession tax credit as amended in TEFRA, with five principal modifications.

First, the cost sharing payment required for companies that elect the cost sharing option is set equal to 110 percent of the payment required under present law.

Second, for companies that elect the profit split option, the amount of product area research expenditures (as determined under the cost sharing rules) is increased by 20 percent for purposes of computing combined taxable income. This increases the amount of income allocable to nonpossession affiliates by no more than the increase under the bill for companies that elect the cost sharing option.

For example, under present law, if product area research expenditures allocable to the product are $10 for a taxable year, then at least $10 of research cost must be taken into account in computing the product's combined taxable income for that taxable year. The bill requires that at least $12 (120 percent of $10) of research cost be taken into account in computing the product's combined taxable income. Consequently, the combined taxable income from sales of the product would be reduced by at most $2 ($12 minus $10), and the amount of income allocable to nonpossession affiliates is increased by at most $1 (50 percent of $2) for companies electing the profit split option. Similarly, for companies electing the cost sharing option, the bill requires an increase in the cost sharing payment for this product, and thus the amount of income allocable to nonpossession affiliates, of $1 (10 percent of $10).

Third, the bill changes the active trade or business test that a U.S. corporation must meet to qualify for the possession tax credit. Under present law, 65 percent or more of a possessions corporation's gross income for the three-year period immediately preceding the close of the taxable year must be derived from the active conduct of a trade or business in the possessions. Under the bill, the

active income percentage increases from 65 percent to 75 percent for tax years beginning after 1986. The bill does not alter the present law requirement that 80 percent or more of gross income for a three-year period be derived from sources within a possession. As under present law, a possessions corporation must meet both the 80-percent possession source income test and the active trade or business test.

Fourth, the bill modifies the rule in present law (sec. 936(b)) which denies the credit with respect to income received in the United States (not including possessions thereof). The credit is not denied for tax on otherwise eligible active business income solely by reason of receipt in the United States where such income is received from an unrelated party. Present law is retained for investment income and for business income received from related parties.

Fifth, the bill modifies the definition of qualified possession source investment income ("QPSII") in order to allow the Government of Puerto Rico to fully implement its initiative to increase investment and employment in qualified Carribean Basin Initiative ("CBI") countries. Under present law, QPSII is limited to income derived from investments within a possession in which the taxpayer conducts an active trade or business. Further, the taxpayer must establish that QPSII is derived from the investment of funds which (1) are allocable to net income from the conduct of an active trade or business within the possession, or (2) constitute a reinvestment of QPSII. The government of Puerto Rico has established rules (Reg. 3087) which apply to financial institutions that accept deposits from possessions corporations. The purpose of these rules is to require that such deposits be invested only in specified assets located in Puerto Rico including: loans for commercial, agricultural, and industrial purposes; business and residential mortgage loans; loans and investments in securities of the Government of Puerto Rico and its instrumentalities; student loans; and automobile loans. In addition, financial institutions are required to invest 30 percent of possessions corporation deposits in Puerto Rico government obligations, including 10 percent in obligations of the Government Development Bank for Puerto Rico ("GDB").

Under the bill, the definition of QPSII is expanded to include certain investments outside of the possessions. Subject to such conditions as the Secretary of the Treasury may prescribe by regulations, QPSII includes income derived from loans by qualified financial institutions (including the GDB and the Puerto Rico Development Bank) for the acquisition or construction of active business assets and for construction of development projects located in qualified CBI countries. To qualify for QPSII treatment, such loans must be approved by the GDB pursuant to regulations issued by the Secretary of the Treasury of Puerto Rico.

A qualified CBI country is defined as a "beneficiary country" (within the meaning of section 212(a)(1)(A) of the Caribbean Basin Economic Recovery Act) which meets the requirements of clauses (i) and (ii) of Code section 274(h)(6)(A). A development project generally means an infrastructure investment, such as a road or water treatment facility, that directly supports industrial development. Active business assets generally means plant, equipment, and inventory associated with a manufacturing operation.

To qualify, a financial institution must agree to permit the Secretary and the Secretary of the Treasury of Puerto Rico to examine such of its books and records as may be necessary to ensure compliance with these provisions. In addition, the borrower and the lending institution must certify to the Secretary and the Secretary of the Treasury of Puerto Rico that the funds will be invested promptly in active business assets or a development project located in a qualified CBI country. The committee anticipates that the lending institution will terminate such a loan if the Secretary or the Secretary of the Treasury of Puerto Rico determines that the borrower has not made a good faith effort to comply with the conditions of certification. Also, it is anticipated that the Government of Puerto Rico will make conforming changes in regulations to permit a local tax exemption for the income attributable to qualified CBI loans.

The committee intends to exercise its oversight jurisdiction to review periodically the operation of the possession tax credit to ensure that the goals of economic development in both the possessions and the Caribbean Basin are being achieved. The committee anticipates that the Government of Puerto Rico will promote employment-producing investment in, as well as the transfer of technology to, qualified CBI countries. The committee believes that economic growth in the relatively poorer CBI countries will benefit both Puerto Rico and the United States by expanding trade opportunities and promoting political stability.

The bill also amends section 936(d)(1) to include the U.S. Virgin Islands within the definition of "possession". This change has the effect of bringing U.S. corporations doing business in the Virgin Islands within section 936, rather than the separate but comparable provisions of the revised organic Act of the Virgin Islands and section 934.

Effective Date

The provision is effective for taxable years beginning after December 31, 1986.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $27 million in 1987, $45 million in 1988, $45 million in 1989, $50 million in 1990, and $54 million in 1991.

2. Taxation of U.S. Government Employees in Panama (Sec. 642 of the bill and sec. 912 of the Code)

Present Law

The Panama Canal Commission is a U.S. Government agency that carries out the responsibilities of the United States under the Panama Canal Treaty with respect to the management, operation, and maintenance of the Panama Canal. An agreement between the United States and Panama entered into in conjunction with the Panama Canal Treaty (Agreement in Implementation of Article III) specifies the rights and legal status of the Commission and its employees. One article of the agreement provides an exemption from tax for U.S. employees of the Commission. In a diplomatic note,

Panama has confirmed the United States' explanation that the exemption was intended to apply solely to Panamanian taxes. A similar agreement between the United States and Panama governs the status of U.S. military installations and employees in Panama.

U.S. Government employees stationed abroad are generally permitted to exclude from gross income certain housing, cost-of-living, and other allowances under Code section 912. The exclusions under section 912 apply only to allowances granted under certain specifically-enumerated statutory provisions. The statutes providing allowances and other benefits to U.S. employees of the Panama Canal Commission are not enumerated in section 912.

In 1984, Congress amended the Panama Canal Act of 1979 to allow the Defense Department to grant quarters allowances to its employees in Panama. Section 912 was not amended to cover allowances granted under the Panama Canal Act, however. Defense Department employees in countries other than Panama receive allowances under an earlier law, the Overseas Differentials and Allowances Act, which is specifically referred to in section 912.

Reasons for Change

The Agreement in Implementation of Article III of the Panama Canal Treaty has been the subject of a substantial amount of litigation. Taxpayers have taken the position that the Agreement exempts the salaries of U.S. employees of the Panama Canal Commission from both U.S. and Panamanian taxation. Although most courts have upheld the U.S. Government's interpretation of the treaty, see, e.g., Coplin v. U.S., 761 F.2d 688 (Fed. Cir. 1985), one appeals court excluded from consideration the U.S. explanation and Panamanian diplomatic note, and held that the plain language of the treaty requires a complete exemption from all taxes. Harris v. U.S., No. 84-8424 (11th Cir. 1985). Similar controversy may exist with respect to the Agreement in Implementation of Article IV.

Although the Harris court's reading of the agreement may have been supported by the limited evidence before the court, the committee believes that such a reading of the agreement is inconsistent with the intent of the drafters and with the views of Congress as reflected in well-established U.S. treaty policy. The United States' technical explanation of the agreement, the Report of the Senate Foreign Relations Committee, and the diplomatic note provided by Panama establish that the treaty was not intended to provide a complete exemption from all taxes for Commission employees. Furthermore, the provision of any such benefit under the treaty would have been inconsistent with the treaty policy of the United States not to alter by treaty the U.S. tax treatment of U.S. persons. The committee finds nothing in the legislative history to indicate that Congress intended to contravene its well-established policies in this regard, in entering into the Panama Canal Treaty and its implementing agreements. In fact, the legislative history indicates that no such contravention was intended.

While the committee does not believe that employees of the Panama Canal Commission or civilian employees of the Defense Department should be granted preferential tax treatment, neither does it believe that they should be treated worse than comparable

overseas employees of the United States. Thus, such employees should be permitted to exclude from gross income allowances comparable to the allowances paid to certain other U.S. Government employees overseas.

Explanation of Provision

The bill clarifies that nothing in the Panama Canal Treaty (or in any agreement implementing the treaty) is to be construed as exempting any citizen or resident of the United States from U.S. tax on any item of income. However, in order to preserve the litigation rights of persons under current law, the clarification applies only to future years. However, no inference is intended that current law is contrary to the bill's provision.

The bill also provides that employees of the Commission and civilizan employees of the Defense Department stationed in Panama may exclude from gross income allowances which are comparable to the allowances excludable under Code section 912(1) by employees of the State Department stationed in Panama. The committee intends by this exclusion to equalize the treatment of U.S. Government employees stationed in Panama, and thus does not intend to permit the exclusion of amounts greater than those that could be excluded by State Department employees, nor to permit the exclusion of allowances of any type unavailable to State Department employees.

Effective Date

These provisions are effective for taxable years beginning after 1986.

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by less than $5 million per year.

3. Reduction of Foreign Earned Income Exclusion; Disallowance of Exclusion for Individuals in Foreign Countries in Violation of Law (secs. 943 and 988 of the bill and sec. 911 of the Code)

Present Law

A U.S. citizen or resident is generally taxed on his or her worldwide income, with the allowance of a foreign tax credit for foreign taxes paid on the foreign income. However, under Code section 911, an individual who has his or her tax home in a foreign country and who is either present overseas for 330 days out of 12 consecutive months or who is a bona fide resident of a foreign country for an entire taxable year can elect to exclude an amount of his or her foreign earned income from his gross income. The maximum exclusion is $80,000 in 1986, and is scheduled to increase to $85,000 in 1988, $90,000 in 1989, and to $95,000 in 1990 and thereafter.[9]

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[9] This scheduled increase in the exclusion was set in the Deficit Reduction Act of 1984. Under the Economic Recovery Tax Act of 1981, the exclusion was scheduled to increase to $85,000 in 1984, $90,000 in 1985, and to $95,000 in 1986 and thereafter.

An individual meeting the eligibility requirements may also elect to exclude (or deduct, in certain cases) housing costs above a floor amount. The combined earned income exclusion and housing amount exclusion may not exceed the taxpayer's total foreign earned income for the taxable year. The provision contains a denial of double benefits by reducing such items as the foreign tax credit by the amount attributable to excluded income.

Reasons for Change

In connection with the lowering of tax rates for U.S. individuals, the committee has repealed or restricted a great number of tax preferences. In this context, the committee believes that it is appropriate to reduce the maximum potential preference for Americans earning active income abroad.

In addition, the committee believes that it is inappropriate to extend any foreign earned income exclusion or housing benefit to individuals who are in foreign countries in violation of U.S. travel restrictions carrying criminal sanctions.

Explanation of Provisions

a. Foreign earned income exclusion amount

The bill limits the foreign earned income exclusion to $70,000 per year per U.S. individual. As under present law, the exclusion is computed at the annual rate on a daily basis.

b. Disallowance of exclusion for individuals in foreign countries in violation of law

The bill provides that individuals who are present in a country with respect to which restrictions relating to travel transactions are in effect will lose certain tax benefits, described below. An individual who is present in a foreign country with respect to which U.S. citizens and residents generally are prohibited from engaging in travel transactions will not lose tax benefits unless that individual's engaging in travel transactions is in violation of law.

For the purposes of this provision, presence in a country will generally result in loss of the earned income exclusion if regulations pursuant to the Trading with the Enemy Act or the International Emergency Economic Powers Act prohibit U.S. citizens and residents from engaging in transactions related to travel to, from, or within that country. Under the bill, an individual will not be treated as a bona fide resident of, or as present in, a foreign country for any day during which the individual is present in a country in violation of law. Foreign earned income, otherwise eligible for the exclusion, will not include any income from sources within such a country attributable to services performed therein. Housing expenses eligible for tax benefits will not include any expenses (allocable to a period in which presence was prohibited) for housing in such a country or for housing of the spouse or dependents of the taxpayer in another country while the taxpayer is present in such a country.

The committee understands that, under Treasury regulations, transactions related to travel of U.S. citizens and residents in five

countries have been generally prohibited currently, except pursuant to consent of the Treasury Department. These countries are North Korea, Cuba, Vietnam, Kampuchea, and Libya. In certain cases, exceptions to these prohibitions are available. These exceptions differ for the various countries. For instance, American individuals may be present in Cuba to visit close family members, to engage in journalistic activity, or to perform research. The rules related to prohibiting travel transactions with respect to Libya, by contrast, prohibit all travel transactions in Libya after January 31, 1986, unless necessary to effect the individual's departure from Libya or for journalistic activity by persons regularly employed in such capacity by a newsgathering organization. Accordingly, the bill will not deny tax benefits to U.S. persons present in Libya to report news for a newspaper or television network, because such persons will not be engaging in transactions there in violation of law.

The bill will apply to the extent that any future changes in law prohibit transactions related to travel to, from, or within foreign countries. If future changes occur, presence in these countries from the effective date of the change will constitute presence that does not qualify for tax benefits under the bill.

Effective Date

These changes are effective for all taxable years beginning on or after January 1, 1987.

Revenue Effect

These provisions are expected to increase fiscal year budget receipts by $24 million in 1987, $34 million in 1988, $45 million in 1989, $56 million in 1990, and $61 million in 1991.

4. Compliance Provisions Applicable to U.S. Persons Resident Abroad; Green Card Holders (sec. 986(a) and (b) of the bill and sec. 3405 and new sec. 6039E of the Code)

Present Law

U.S. citizens who live abroad are required to file U.S. tax returns and pay U.S. tax on their worldwide income, just as they are required to do when they live in the United States. In addition, it is possible for an alien to be considered a resident of the United States even during periods when he is living outside of the United States; such persons therefore continue to have the same duty to file and pay tax as any other U.S. citizen or resident. Certain special rules apply to U.S. citizens and residents who live abroad, such as section 911's limited exclusion of foreign earned income. In addition, credits against tax may be available to such persons for foreign taxes paid on their foreign source income.

Reasons for Change

Failure to file

The committee is concerned that a substantial percentage of U.S. persons resident overseas may fail to comply with the requirement

that they file U.S. tax returns. The General Accounting Office has gathered evidence suggesting that the percentage of taxpayers who fail to file returns is substantially higher among Americans living abroad than it is among those resident in the United States. Such nonfilers may consist of two general types. First, there are the negligent nonfilers: those who assume that their residence overseas exempts them from U.S. tax, and those who think that they need not file if section 911 and/or foreign tax credits eliminate their U.S. tax liability. Second, there are fraudulent nonfilers, those who know their duty to pay U.S. tax but do not fulfill it. The committee believes that both of these cases present significant compliance problems that must be addressed.

With respect to the first case, the negligent nonfiler, the committee emphasizes that it is important that a return be filed even by those who believe their U.S. tax liability to be zero (as long as their gross income exceeds the return filing threshold). The Internal Revenue Service should have the opportunity to determine that taxpayers with significant gross income have properly applied the provisions relevant to the determination of their liability. Since the foreign tax credit is among the most difficult provisions of the Code, it is particularly important that the Service have an opportunity to review the application of those provisions by citizens and residents abroad. In addition, ensuring regular filing by such persons may help prevent inadvertent nonfilers from becoming habitual and fraudulent nonfilers.

With respect to the second case, the fraudulent nonfiler, it is obviously important to the integrity of the Federal tax system that the government have the ability to detect and bring to justice those who evade their share of the tax burden.

The committee believes that both cases should be addressed by requiring that an Internal Revenue Service information return be completed in conjunction with the processing of applications for passports in the case of citizens, and permanent resident visas ("green cards") in the case of resident aliens. Such a requirement would serve to notify inadvertent nonfilers of their continuing duty to file a U.S. tax return. Presumably a substantial number of such nonfilers would respond by filing their returns. In addition, of course, such a requirement would provide the IRS with information that would enable it to contact nonfilers and, if necessary, initiate collection actions. The committee recognizes that the present ten-year validity of passports means that such information would only be collected at infrequent intervals. Nevertheless, the committee believes that the occasional provision of such information would represent a substantial improvement over present law, which provides the IRS with far fewer opportunities to obtain information concerning U.S. taxpayers living abroad. U.S. persons would no longer be able to move overseas and drop out of the U.S. tax system entirely; occasional reporting in conjunction with renewal applications will ensure ongoing opportunities to locate such persons.

Collection of tax

Even when overseas nonfilers are identified, enforcement is often difficult because the IRS is rarely able to collect tax in a foreign country. The Service must instead attempt to locate assets within

the United States which can be seized to satisfy a nonfiler's tax liability; if the nonfiler has taken most of his assets abroad, collection may be impossible.

Pension payments are generally subject to withholding only at the taxpayer's election. Such payments often represent a substantial stream of income to U.S. persons resident overseas who are relatively likely to owe U.S. tax on such income (because the section 911 exclusion does not apply to it). Therefore, the committee believes that it will be appropriate to require withholding with respect to pension payments to persons with foreign addresses absent a showing that withholding is not required.

Explanation of Provisions

Failure to file

The bill provides that an IRS information return must be filed in conjunction with a citizen's passport application, and with a resident alien's green card application. These returns must provide the individual's taxpayer identification number, any foreign residence of a passport applicant, information with respect to whether a green card applicant has been required to file a tax return, and such information as the Secretary may require. In addition, the committee expects that the instructions accompanying these information returns will clearly explain the filing requirements applicable to citizens and residents living abroad. A new penalty of $50 will generally apply with respect to a failure to file the required return, in addition to any other applicable penalties (such as the criminal penalties provided in section 7203 for willful failures to comply with the reporting and other requirements of the Code). Any U.S. agency collecting these returns is to provide them to the Secretary.

Collection of tax

The bill provides that pension benefits (and similar payments) will be subject to withholding under section 3405 if delivered outside the United States. The election generally available under section 3405 to forego withholding will not be available in such cases. This automatic withholding will not apply if the recipient certifies to the payor that he or she is not a U.S. person resident overseas (or a tax avoidance expatriate (sec. 877)). The committee expects that such a certification may appropriately be provided for by modifying forms prescribed by the Secretary for the use of payees making the election to forego withholding under section 3405.

Effective Date

The reporting requirement applies to passport and green card applications filed after 1986.The withholding requirement applies to payments made after December 31, 1986.

Revenue Effect

The provisions are estimated to increase fiscal year budget receipts by less than $5 million per year.

5. Taxation of Foreign Investment Company Income (sec. 925 of the bill and sec. 1246 and new sec. 1246A of the Code)

Present Law

U.S. taxation of foreign persons

Although U.S. corporations are subject to current U.S. taxation on worldwide income, foreign corporations are generally subject to U.S. taxation only on their U.S. source income and income from a U.S. business. Foreign corporations are generally exempt from U.S. taxation on foreign source income.

Taxation of U.S. shareholders of foreign corporations

The United States generally imposes tax on the U.S. shareholder of a foreign corporation only when that shareholder receives the foreign corporation's earnings in the form of a dividend. That is, the U.S. shareholder of a foreign corporation generally may defer tax on that income until receipt of dividends.

The subpart F provisions of the Code provide an exception to this general rule of deferral. Under these provisions, income from certain "tax haven" or other activities conducted by corporations controlled by U.S. shareholders is currently taxed to the corporation's U.S. shareholders without regard to whether they actually receive the income currently in the form of a dividend. However, these subpart F rules apply only if more than 50 percent of the voting power in the foreign corporation is owned by U.S. persons each of whom owns (directly or indirectly) at least a 10-percent interest in the corporation. Moreover, even if ownership is so concentrated that the subpart F rules apply, the rules apply only to those U.S. persons who are considered to own 10 percent or more of the voting power in the foreign corporation. Thus, a less than 10-percent shareholder in a controlled foreign corporation can avoid current recognition of income under these provisions.

Two other similar sets of rules, the personal holding company rules and the foreign personal holding company rules, could also subject foreign corporations or their U.S. shareholders to current taxation on passive investment income or futures trading income, but these rules apply only if five or fewer individuals own (directly or indirectly) more than 50 percent in value of the stock of a foreign corporation. Thus, these provisions may be avoided by dividing ownership evenly between U.S. and foreign individuals (in the case of the foreign personal holding company rules) or by dispersing majority-ownership among more than five individuals (in the case of either set of rules).

Shareholder level tax on disposition

Code rules attempt to prevent U.S. shareholders of foreign corporations from repatriating earnings of those corporations at present law's lower capital gains rates after deferring tax on those earnings. For example, gains derived by a U.S. person who is a 10-percent shareholder (at any time during a five-year period) in a controlled foreign corporation (defined as in the subpart F rules) on the disposition of that corporation's stock are subject to ordinary income (dividend) treatment rather than capital gains treatment to

the extent of that person's share of the post-1962 earnings and profits of the controlled foreign corporation (Code sec. 1248). (Capital gain treatment will still apply under the bill to corporate taxpayers and in certain other cases.)

However, section 1248's scope is limited. Wide dispersal of a foreign corporation's stock ownership can avoid controlled foreign corporation status. Even if the foreign corporation is controlled by U.S. shareholders, a less than 10-percent shareholder may dispose of his investment and potentially receive capital gain treatment for the increase in value of his investment.

Another provision, the foreign investment company provision (sec. 1246), was enacted in 1962 along with the subpart F rules to prevent U.S. investors from receiving capital gains treatment on disposition of their stock when U.S. ownership in the foreign corporation was widely dispersed but total U.S. ownership exceeded 50 percent and the foreign corporation primarily invested in securities. As amended, the provision generally applies to any U.S.-majority owned foreign corporation that is either (1) registered under the Investment Company Act of 1940 either as a management company or as a unit investment trust or (2) engaged primarily in the business of investing or trading in securities (as defined in section 2(a)(36) of the Investment Company Act of 1940) or commodities or interests therein. A foreign investment company is considered U.S.-majority owned under this provision if 50 percent or more of its stock (by value or by voting power) is held (directly or indirectly) by U.S. persons. When a U.S. person disposes of stock in a foreign investment company, that person is subject to ordinary income treatment to the extent of his share of the foreign investment company's post-1962 accumulated earnings and profits, but not to exceed the person's gain on the disposition.

Under present law, sections 1248 and 1246 may apply to the same factual situation. For example, if a controlled foreign corporation has a 10-percent owner and the corporation is in the business of investing in securities, both provisions may potentially apply in the event the 10-percent owner disposes of his stock. Under present law, section 1246 may be considered to take priority. Since an inclusion under section 1248 may bring with it a deemed-paid credit for taxes paid by a foreign corporation but a section 1246 inclusion will not, the deemed-paid foreign tax credit is not available in such circumstances.

Reasons for Change

The committee understands that the abuses the Congress was concerned with in 1962 when the foreign investment company provisions were enacted have advanced to a point where present law is basically inoperative. The committee is aware that present foreign corporations that invest in passive assets limit U.S. ownership in such funds so that section 1246 rarely applies.

The committee is concerned that U.S. persons who invest in passive assets through a foreign investment company obtain a substantial tax advantage vis-a-vis U.S. investors in domestic investment companies because they avoid current taxation and are able to convert income that would be ordinary income if received directly or received from a domestic investment company into capital gain

income. The committee does not believe that tax rules should effectively operate to provide U.S. investors tax incentives to make investments outside the United States rather than inside the United States. In the committee's view, U.S. persons who invest in passive assets should not be able to achieve tax deferral just because they invest in those assets indirectly through a foreign corporation.

The committee recognizes, however, that the extension of current taxation treatment to U.S. investors in passive foreign investment companies (PFICs) could create difficulties for such investors in cases where the U.S. investors do not have ongoing access to the PFICs' records relating to their earnings and profits, do not have control sufficient to compel dividend distributions, or do not have sufficient liquidity to meet a current tax liability before they directly realize income from their PFIC investment. For these reasons, the committee considered it appropriate to adopt a taxing mechanism which allowed U.S. investors both to compute their income from the PFIC based upon certain reasonable assumptions, and to delay payment of their tax liability until they actually realized cash from their PFIC investment through distributions or dispositions, provided that any such delayed tax payment would be subject to an interest charge. The committee notes that present law contains similar interest charge provisions on certain types of deferred income (*e.g.*, accumulation distributions from foreign trusts under section 668 and interest charge DISCs under section 995).

For those U.S. investors in PFICs who are not concerned about the difficulties described above with respect to current taxation, the committee also considered it appropriate to allow an election for actual current taxation on a PFIC's actual earnings and profits, based on the subpart F model.

The committee recognizes it is difficult for some U.S. investors who invest in foreign corporations to obtain sufficient information with which to complete their tax return and pay their correct tax liability. In these cases, the committee believes that attributing income over the holding period of the investment, together with the imposition of an interest charge, will eliminate the economic benefit of deferral without imposing an informational burden on the U.S. investors.

In circumstances where U.S. investors in foreign investment companies are able to obtain sufficient information, however, the committee believes that they should not be disadvantaged. In these circumstances, the committee believes that U.S. investors should be entitled to flow-through treatment for capital gain income when the corporation earns such income.

Explanation of Provision

Overview

The bill generally provides that U.S. persons who invest in a newly defined category of a foreign investment company, a passive foreign investment company (PFIC), must pay tax and an interest charge on gain derived from the disposition of the investment or on distributions from the company. This system is intended to eliminate the economic benefit of tax deferral. Taxpayers who are currently informed by a corporation of their share of earnings may,

alternatively, elect to be subject to tax currently on their share of the company's annual earnings and profits. Under either method, the bill allows a U.S. person to characterize his gain (or distributions) on the basis of capital gain income and ordinary income earned by the corporation if he can show to the satisfaction of the Secretary how much of his income is attributable to each category.

Passive foreign investment company

The new passive foreign investment company (PFIC) is defined by the bill to mean any foreign corporation if 75 percent or more of its gross income for the taxable year consists of passive income, or any foreign corporation if 50 percent or more of the average yearly value of its assets consists of assets that produce, or are held for production of, passive income. For example, corporate stock paying no current dividends is intended to be a passive asset for this purpose. Passive income is defined for purposes of the bill's PFIC definition to mean income that is includible in the new passive income separate foreign tax credit limitation provided in section 901 of the bill (new Code sec. 904(d)(2)(A)). Thus, passive income generally includes portfolio dividends, interest, passive rents and royalties, gains from the disposition of stocks and securities and certain other assets, certain gains from commodity trading, and certain foreign currency exchange gains.

The committee does not intend that holding companies formed to own active operating subsidiaries be treated as PFICs. The bill avoids this result by providing look-through rules in characterizing amounts such as interest and dividends received from foreign or domestic subsidiaries. The bill generally provides that interest, dividends, rents, and royalties received from a lower-tier foreign or domestic subsidiary are passive income for this purpose only to the extent the payor corporations earn passive income. Thus, a foreign holding company that receives dividends or interest from a subsidiary is not treated as receiving passive income unless the subsidiary derives passive income. A corporation is a "subsidiary" of a second corporation for these purposes if at least 50 percent of its voting stock is owned by the second corporation.

The bill excludes from the definition of a PFIC any foreign investment company described in Code section 1247 (i.e., foreign investment companies that made an election before 1963 to distribute their income currently).

The bill further excludes from the definition of a PFIC a corporation during a start-up period that may initially generate only passive income. This exception provides that a foreign corporation is not considered a PFIC for the first year the corporation receives gross income if (1) any predecessor of the corporation was not a PFIC; (2) the corporation satisfies the Secretary that it will not be a PFIC for either of the first two taxable years following the start-up year; and (3) the corporation is not in fact a PFIC for either of these years.

Imposition of tax and interest charge

The bill provides a special tax regime for U.S. persons who own stock of a PFIC and do not elect to be currently taxed on their share of the PFIC's earnings. The bill provides that the amount of

any distribution of property (including money) with respect to PFIC stock and the amount of any gain on any disposition of stock of a PFIC is treated as ordinary income and deemed to be earned pro rata over the holding period of the stock. For example, if a U.S. person acquires stock of a PFIC for $1,000 at the beginning of year 1 and sells the stock for $2,000 at the end of year 5, the gain of $1,000 is deemed to be earned $200 each year. Tax, increased by an interest charge, is then imposed for the earnings attributed to each year. The tax is imposed at the highest rate of tax imposed under the Code with respect to the applicable taxpayer, without regard to other operations of the taxpayer in earlier years. The committee believes that this rule is appropriate because of the low top rates that this bill provides. The interest charge is based on the rate and method prescribed in Code section 6621. In the example above, then, the U.S. person would owe in year 5 the sum of the tax due on $200 (from year 1) plus interest compounded for four years, the tax due on $200 (from year 2) plus interest compounded for three years, the tax due on $200 (from year three) plus interest compounded for two years, and so on. In the example above, if, instead of selling his investment, the U.S. person receives a distribution of $500 in year 5, the $500 would be deemed to have been earned $100 in each of years 1 through 5 and would generate a tax and interest charge on similar principles.

The bill provides, however, that instead of the gain (or distribution) being treated as ordinary income, the taxpayer may identify that portion of the gain (or distribution) that is attributable to net long-term and short-term capital gain income of the PFIC. Any gain identified as capital is considered to be earned in the year in which it was earned by the PFIC. The identification is to be made for the year of disposition, or in the year distributions are received. Identifying any portion of income as capital gain is contingent upon satisfying the Secretary that the identification is appropriate.

The committee intends that if a taxpayer identifies any portion of gain on the disposition of stock of a PFIC as capital gain and the taxpayer's share of earnings of the PFIC is greater than his total gain, then only a proportional amount of the total gain be treated as capital. In the example above, if the taxpayer's share of the PFIC's actual earnings over the 5-year holding period would have been $1200 and the taxpayer establishes that $600 of the earnings are capital gains, because the amount subject to tax is limited to $1000, only $500 of the amount taxable can be treated as capital; the remaining $500 is treated as ordinary income.

For purposes of the bill, a person is treated as disposing of his stock in a PFIC if he uses the stock as security for a loan.

In determining stock ownership, a U.S. person is considered to own his proportionate share of the stock of a PFIC owned by any partnership, trust, or estate of which the person is a partner or beneficiary, or owned by any foreign corporation if the U.S. person owns 50 percent or more of the value of the corporation's stock. However, if a U.S. person owns any stock of a foreign corporation which is also a PFIC, such person is considered to own his proportionate share of any PFIC stock owned by the corporation, regardless of the percentage of his ownership of the first PFIC.

Election to be subject to current taxation

The bill provides that a U.S. person may elect out of the bill's special tax regime by being subject to current tax on his share of the PFIC's annual earnings and profits. Under the bill, an electing shareholder is treated as a U.S. shareholder of a controlled foreign corporation subject to the current taxation rules of subpart F. Because the PFIC's earnings will generally be all passive income, each electing U.S. person will be taxed on his share of all the PFIC's earnings and profits. If a PFIC is defined by the 50-percent asset test, all of its income may not be passive. In this case, the 70-percent rule of Subpart F (sec. 954(b)(3)), which provides that if a controlled foreign corporation's foreign base company income exceeds 70 percent of the corporation's gross income, then all of the corporation's income is treated as foreign base company income) may not cause all of the PFIC's earnings to be taxed.

Consistent with the committee's intention not to disadvantage U.S. persons who invest in a PFIC rather than a domestic investment company, the bill provides that a U.S. person can segregate his share of the PFIC's current earnings and profits into long-term and short-term capital gain income and ordinary income generated by the PFIC. That portion of the U.S. person's subpart F inclusion in any taxable year which is attributable to the PFIC's capital gain income for its taxable year shall be treated as capital gain income of the U.S. person. The U.S. person must, however, provide sufficient records to satisfy the Secretary that any characterization of income as capital gain is appropriate.

The bill provides that the election to be subject to current taxation must be made in the taxpayer's return for the first taxable year of his investment in a PFIC, or in the case of any shares of a PFIC held on the bill's effective date, in the first taxable year beginning after the effective date. Any election under the bill can be revoked only with the consent of the Secretary.

The bill also provides that, if a U.S. person elects to be subject to current taxation, if the PFIC is not otherwise a controlled foreign corporation, and if the U.S. person is not otherwise a U.S. shareholder, then section 956, relating to inclusion of increase in earnings invested in U.S. property, will not apply. This provision prevents a small investor in a PFIC who does not have any control over a PFIC's investments from being subjected to tax on a PFIC's investment in U.S. property.

The election of subpart F treatment does not render the electing shareholder eligible for the benefits of the section 960 foreign tax credit provision where such shareholder would otherwise be ineligible if the PFIC were actually a controlled foreign corporation (*i.e.*, a corporation owning less than 10 percent of the voting stock).

Anti-avoidance rules

The bill provides that if a PFIC is otherwise a controlled foreign corporation and any U.S. investor is otherwise a U.S. shareholder, the bill's provisions do not apply and the U.S. investor is subject to the rules of subpart F.

The bill provides regulatory authority to the Secretary necessary to carry out the purposes of the bill's provisions and to prevent circumvention of the interest charge.

As an example, the ownership attribution rules of the bill attribute the ownership of PFIC stock (in the event of an intervening corporation) only to a U.S. person that owns 50 percent of the intervening corporation. A foreign corporation engaged in an active trade or business will not normally be a PFIC. If such a corporation issues a separate class of stock and uses the proceeds to invest in a PFIC or to invest directly, the corporation will still probably not be a PFIC under the general definition. However, in these instances, it may be necessary to treat the separate issue of stock as a separate corporation for this purpose. In that event, the separate corporation will in all likelihood be a PFIC and the attribution rules will attribute any lower-tier PFIC stock to the ultimate U.S. investors.

Another instance where regulations may be necessary to carry out the purposes of these provisions is where the ownership attribution rules attribute stock ownership in a PFIC to a U.S. person and the U.S. person disposes of his interests in an intervening entity. In these cases, the intervening entity may not be a PFIC in which case the U.S. person could technically avoid the imposition of any interest charge. The committee intends, however, that regulations will treat the disposition of the interests in the intervening entity as a disposition of the PFIC stock in appropriate cases.

The bill also provides two conforming amendments. First, if a PFIC is also a controlled foreign corporation, gain from the disposition of PFIC stock by a 10-percent shareholder is to be taxed under section 1248 instead of the new provisions. Similarly, section 1246 is amended to clarify that gain from the disposition of stock by a 10-percent shareholder of a foreign investment company that is also a controlled foreign corporation is to be taxed under section 1248. These amendments allow a 10-percent corporate shareholder to claim a deemed paid foreign tax credit.

Effective Date

The provision is effective for taxable years of foreign corporations beginning after December 31, 1986.

The bill provides that pre-effective date earnings of foreign corporations that become PFICs under the bill are to be taxed as under current law, but only with respect to the bill's interest charge provision. For example, a U.S. person has owned stock in a foreign corporation since January 1, 1984. The corporation is a PFIC under the bill. The U.S. person disposes of his stock on December 31, 1988, at a gain of $1000. The income that is attributed to years 1984–1986 ($600) will not be subject to the interest charge. However, all of the gain will be treated as ordinary income unless the U.S. person can satisfy the Secretary that a portion of his gain is attributable to capital gains of the PFIC.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $10 million in 1987, $17 million in 1988, $16 million in 1989, $19 million in 1990, and $20 million in 1991.

E. Treatment of Foreign Taxpayers

1. Branch Profits Tax (sec. 951 of the bill and secs. 861 and 881, and new sec. 884 of the Code)

Present Law

The United States generally seeks to tax dividends and interest paid by foreign corporations most of whose operations are in the United States in the same manner as dividends and interest paid by U.S. corporations that operate in the United States. If the recipient of the dividends or interest is a U.S. person, the United States imposes tax on the dividends or interest at the regular graduated rates. If the recipient of the dividends or interest is a foreign person, however, symmetry is more difficult to achieve.

A U.S. corporation that pays dividends to a foreign person not engaged in a trade or business in the United States generally must, in the absence of a contrary treaty provision, withhold 30 percent of the payment as a tax. The United States imposes the tax at a flat 30-percent rate because it is generally not feasible to determine and collect a net-basis graduated tax from foreign persons who may have very limited tax contacts with the United States. Similarly, a 30-percent withholding tax applies to some interest paid to foreign persons, including interest paid to related parties and certain interest paid to banks. In addition, U.S. income tax treaties reduce or eliminate the tax on interest paid to residents of the treaty country and reduce the tax on dividends paid to treaty residents to as little as 5 percent.

Similarly, a foreign corporation, most of whose operations are in the United States, that pays dividends or interest (of the types taxable if paid by a U.S. corporation) to a foreign person must withhold a portion of the payments (this is sometimes referred to as a second-level withholding tax). A foreign corporation becomes liable to withhold only when more than half of its gross income for a 3-year period is effectively connected with a U.S. trade or business. If the 50-percent threshold is crossed, the 30-percent (or lower treaty rate) tax applies to the allocable portion of the payment attributable to income of the paying foreign corporation that is effectively connected with its U.S. trade or business. One function of this withholding tax is to treat payments by foreign corporations with U.S. operations like payments by U.S. corporations.

Reasons for Change

A U.S. corporation owned by nonresidents is subject to income tax on its profits. In addition, its foreign shareholders are subject to tax (collected by withholding) on the dividends which they receive (30 percent by statute, but frequently reduced to a lesser amount by treaty). Similarly, in certain circumstances interest pay-

ments made by a U.S. corporation to foreign creditors are subject to withholding (30 percent by statute, in the case of interest paid to related parties and in the case of certain bank interest, but frequently reduced or eliminated by treaty). No comparable shareholder-level taxes are imposed by the United States on the distributed profits or remitted interest of a U.S. branch of a foreign corporation (except in the limited case of a U.S. branch of a foreign corporation engaged in the commercial banking business).

Where a foreign corporation chooses to conduct its U.S. operations through a U.S. branch, the second-level withholding taxes of current law sometimes operate in the same way as the dividend and interest withholding taxes that would have applied had the U.S. operations been conducted through a separately incorporated U.S. subsidiary. However, under present law, the second-level withholding taxes apply only when a majority of the income of the foreign corporation is derived from its U.S. branch. Thus, a foreign corporation that derives a substantial amount of U.S. income but also operates extensively in other countries may not be liable for the second-level withholding taxes. Interest and dividend payments made by U.S. corporations, on the other hand, are always subject to two levels of tax unless exempt by treaty or eligible for special Code exemptions, such as portfolio interest. Moreover, the comittee understands that the second-level withholding tax is sometimes difficult to enforce. The committee is informed that it is often difficult to know when the tax is due, and if it is due, it is difficult to enforce its collection by a foreign corporation.

The committee is also concerned that present law—by subjecting U.S. corporations operating in the United States to corporate and shareholder levels of tax but subjecting many foreign corporations operating in the United States to corporate tax only—provides an unintended advantage to foreign corporations vis-a-vis their U.S. competitors.

The committee believes that the disparity between the taxation of U.S. corporations owned by foreign persons and the taxation of U.S. branches of foreign corporations should be reduced. The committee notes that there are corporate and shareholder levels of tax for U.S. corporations owned by U.S. persons and for U.S. corporations owned by foreign persons. The committee understands that nearly all foreign corporations with branches in the United States avoid liability for the second-level withholding tax (if not otherwise avoided pursuant to a tax treaty) because their U.S. income is beneath the 50-percent threshold. The committee has, therefore, concluded that present law's 50 percent threshold is too high. In the committee's view, a foreign corporation doing business in the United States should be subject to the same substantive tax rules that apply to U.S. corporations.

To reduce the disparity in U.S. tax treatment of U.S. subsidiaries and U.S. branches of foreign corporations and the disparity in U.S. tax treatment of U.S. corporations and foreign corporations that operate in the United States, the committee believes that a new branch-level tax should be enacted. In the committee's view, a branch-level tax is an appropriate substitute for a shareholder-level tax: it may be easier to collect than the present second-level withholding tax on dividends and it will not depend for its application,

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as that tax does, on the foreign corporation's U.S. income exceeding an arbitrary threshold.

With respect to a second-level tax on interest, however, the committee is concerned that a branch-level tax on interest may not be an income tax that foreign persons may credit. Moreover, the committee believes, that whenever there is a deduction allowed against U.S. source income that there should generally be an inclusion subject to U.S. tax. The committee, therefore, believes that present law's second-level withholding tax for interest should be retained but that the threshold for determining when the tax applies should be substantially reduced so that the tax applies when the foreign corporation has more than a de minimis amount of U.S. operations when compared with its worldwide operations.

The committee recognizes the value of income tax treaties for U.S. persons engaging in international commerce. The committee further recognizes that most U.S. income tax treaties in force were not negotiated to allow the United States to impose a branch-level tax because such a tax has never existed in the U.S. tax system. Although the committee believes that a branch-level tax does not unfairly discriminate against foreign corporations because it treats foreign corporations and their shareholders together no worse than U.S. corporation and their shareholders, it recognizes that most treaty nondiscrimination articles operate to consider separately corporations and their shareholders in determining whether discriminatory tax rules exist. The committee does not, therefore, generally intend to override U.S. income tax treaty obligations that prohibit imposition of the branch-level tax even though as later-enacted legislation the tax would normally do so. The committee adopts this position, however, with the understanding that the Treasury Department will attempt to renegotiate outstanding treaties that prohibit imposition of the tax.

Notwithstanding the committee's general deference to U.S income tax treaty obligations, the committee is concerned that foreign investors may attempt to use other countries' tax treaties to avoid the branch-level tax and second-level withholding taxes (i.e., they would treaty shop). In these cases, the committee believes the use of such treaties is improper. It is the committee's understanding that the United States foregoes source basis taxation of dividends on the understanding that the residents of the treaty country are taxed in their home country on such income. The committee believes a similar policy applies for interest. In cases of treaty shopping, then, the committee intends the bill to override U.S. treaties.

Explanation of Provision

The bill adopts a branch-level tax on profits of foreign corporations operating businesses in the United States. It also modifies the second-level withholding taxes of current law by reducing the U.S. business thresholds that trigger the taxes, and modifies the determination of U.S. source interest subject to U.S. tax.

Branch profits tax

The bill provides that the base for the branch profits tax, the "dividend equivalent amount," is the income effectively connected with the corporation's U.S. trade or business, subject to two adjustments and an earnings and profits limitation. The first adjustment reduces the tax base to the extent the branch's income is reinvested in the United States. This reduction is measured by the increase in the money and adjusted basis of the branch's assets less its liabilities at the end of the year over the money and adjusted basis of its assets less its liabilities at the beginning of the year. Secondly, the tax base is increased in any subsequent year to the extent those reinvested earnings are remitted to the home office of the foreign corporation. This adjustment is measured by the amount by which the money and adjusted basis of the branch's assets less its liabilities at the beginning of the year exceeds the money and adjusted basis of the branch's assets less its liabilities at the end of the year. It is intended in the latter situation that the increase in the tax base be limited to the amount of the income of the branch received or accrued after the bill's effective date that has been reinvested in the branch.

The dividend equivalent amount is then limited to current and accumulated earnings and profits attributable to the branch's effectively connected income. This limitation ensures that the taxable base is reduced by Federal and foreign income taxes, by capital losses not allowed in computing taxable income, and by other adjustments that would affect the amount of earnings that could be repatriated as a dividend if the branch operated as a corporation.

The committee intends that the branch's earnings and profits be measured pursuant to general Code rules but limited to the branch's activities. For example, tax-exempt interest received or accrued by the branch is included in the earnings and profits limitation even though those amounts are not included in the branch's effectively connected income.

Since the branch profits tax is imposed on income effectively connected with a U.S. trade or business, the tax applies, for example, to foreign corporations that are partners in a partnership that derives income effectively connected with a U.S. trade or business and to foreign corporations that own vessels and aircraft that generate income effectively connected with a U.S. trade or business.

The bill imposes a tax of 30 percent on the dividend equivalent amount. If an income tax treaty between the United States and the country in which the corporation is resident permits the branch profits tax, but reduces the rate, the lower treaty rate applies, unless the owners of the corporation are treaty shopping (as defined below). In treaty shopping cases, the 30 percent rate applies. If a treaty between the United States and the country in which the corporation is resident does not specifically provide for a branch profits tax, but does otherwise permit such a tax, the treaty's direct investment dividend rate is to apply to the branch base, unless the owners of the corporation are treaty shopping whereupon the bill's rate applies. Finally, if a treaty between the United States and the country in which the corporation is resident permits a branch profits tax, but contains a different computation than the bill provides,

or subjects the branch tax to restrictions not in the statute, the bill provides that the tax will be applied subject to the treaty's computation provisions and other restrictions, unless the owners of the corporation are treaty shopping whereupon the bill's provisions apply. For example, the committee understands that the U.S.-Canadian treaty allows a branch tax but that the tax is computed under rules different from the bill's rules; if a Canadian corporation is not treaty shopping, the provisions of the U.S.-Canadian treaty would apply in determining the branch tax payable to the United States.

The bill provides that, in measuring the adjusted basis of its assets and liabilities, the branch is to include only its assets and liabilities that are treated as connected with the conduct of the branch's U.S. trade or business. The bill provides that the includible assets and liabilities are only those assets and liabilities that are directly related to the income of the branch that is effectively connected with the conduct of its U.S. trade or business. For example, the committee intends that the necessary assets include cash necessary to meet day-to-day operating requirements, receivables from the sale of goods or services, inventories, property, plant, and equipment used in the business, investments as long as the income therefrom is effectively connected income, and other assets necessary to operate the business. Includible liabilities mean the day-to-day payables and short-term obligations, long-term obligations incurred to purchase assets used in the business, and other liabilities necessary to meet business obligations.

Regulations

The bill authorizes the Treasury Department to prescribe regulations necessary to carry out the purposes of the provision. The committee expects the Treasury Department will prescribe regulations that, among other things, address the potential abuse that may arise in the event a branch temporarily increases its assets at the end of its taxable year merely to reduce its branch profits tax base. The regulations are also intended to address the extent to which a decrease in assets may not indicate that the branch has remitted profits during the year. For example, the regulations may provide that earnings have not been considered repatriated to the extent the corporation incurs a casualty loss. Another example where the Treasury Department may not consider it appropriate to impose a branch profits tax is the incorporation of a branch where the earnings of the branch are contributed to the new corporation rather than remitted.

Relationship with tax treaties

In general, it is not intended that the bill's branch profits tax apply in situations where its application would be inconsistent with an existing U.S. income tax treaty obligation. The committee understands that it is the Treasury Department's interpretation that if a corporation is organized in a country with which the United States has a treaty that contains a nondiscrimination article similar to the article contained in the United States 1981 Model Income Tax Treaty, such article prohibits the bill's branch profits tax. The committee intends to respect this view.

In the event a treaty with a particular foreign country does not allow a branch profits tax but does allow the Code's second-level withholding tax on dividends, the bill provides that, to that extent, the present law second-level withholding tax is to apply.

However, the bill provides that the branch profits tax is to be imposed in treaty-shopping situations (as defined below), notwithstanding any conflicting treaty provisions. In the event a treaty with the United States prohibits the branch profits tax but it allows a second-level withholding tax on dividends if the corporation derives, for example, 50 percent or more of its income from the United States, and the corporation does in fact derive 50 percent or more of its income from the United States, the bill provides that the second-level withholding tax is imposed pursuant to the treaty's conditions. In the event a treaty with the United States prohibits the branch profits tax and allows a second-level withholding tax on dividends generally but contains conditions similar to those described above before the United States can impose its withholding tax, the bill's branch profits tax is imposed if the owners are treaty shopping and the foreign corporation does not meet those conditions for that year. If the owners are not treaty shopping, no tax (branch profits or second-level withholding) is imposed. In the event a treaty with the United States prohibits both a branch profits tax and any second-level dividend withholding tax generally, the bill's branch profits tax is imposed if the owners of the corporation are treaty shopping.

The committee understands that if a country in which the foreign corporation is organized has a treaty with the United States that has a dividend article similar to Article 10(5) of the United States 1981 Model Income Tax Treaty, the treaty permits the imposition of a second-level withholding tax by the United States. In this case, if treaty shopping is not present and the treaty prohibits the branch profits tax, no second-level withholding tax is imposed if a foreign corporation does not derive at least 50 percent of its income from a permanent establishment in the United States (as provided by the treaty).

The bill provides that a foreign corporation is treaty shopping where more than 50 percent (by value) of the beneficial owners of the foreign corporation are not residents of the treaty country. The bill treats U.S. citizens and resident aliens as residents of the treaty country for this purpose. However, if the foreign corporation's stock is primarily and regularly traded on an established securities market in the country under whose treaty it claims benefits as a resident, the bill provides that it is considered a resident of that country for this purpose. The bill also provides that if the foreign corporation's parent is organized in the same country as the foreign corporation, and the parent corporation's shares are primarily and regularly traded in that country, the subsidiary corporation is considered resident of such country for purposes of the country's treaty with the United States.

The bill also provides that the Secretary is to prescribe regulations regarding other circumstances in which a foreign corporation is not considered to be treaty shopping. For example, the regulations may provide that a corporation is not considered to be treaty shopping in circumstances where a foreign corporation operates an

active trade or business in the country in which it is organized as long as a substantial amount of the corporation's income is not reduced by amounts payable outside the corporation's country of organization.

Second-level withholding taxes

The bill provides that dividends paid by a foreign corporation are U.S. source if at least 10 percent of the corporation's worldwide gross income is effectively connected with the conduct of a U.S. trade or business for the 3-year period ending with the close of the taxable year preceding the payment of the dividends (or for the period of the corporation's existence, if shorter). In these cases, the amount of dividends treated as U.S. source is the ratio of gross income effectively connected with a U.S. trade or business to worldwide gross income of the corporation earned during the base period. The portion of dividends treated as U.S. source is subject to the general Code taxation and withholding rules under sections 871, 881, 1441, and 1442, when the dividends are paid to foreign persons. In determining the withholding rate, if a treaty between the dividend recipient's country of residence and the United States lowers the rate for U.S. source dividends, the lower rate will apply unless the recipient is treaty shopping whereupon the Code's withholding rate applies. The bill provides that if any branch tax is payable, no withholding tax is due.

With respect to interest, the bill provides that a portion of interest paid by a foreign corporation is treated as U.S. source if at least 10 percent of the foreign corporation's worldwide income is income effectively connected with a U.S. trade or business during a 3-year period ending with the close of the taxable year preceding the payment of the interest (or for the period of the corporation's existence, if shorter). The portion of the interest treated as U.S. source is the interest paid multiplied by the ratio of the average interest deduction claimed on the corporation's U.S. income tax return for the base period to the average total interest expense of the corporation for the base period. Any interest treated as U.S. source is subject to Code provisions that may exempt the interest from withholding. For example, the deposit rule of section 871(i)(2)(A) (as modified by sec. 912 of the bill) exempts U.S. source interest from tax when paid by an active banking organization to a foreign person and the interest is not effectively connected with a U.S. trade or business of the foreign person.

The bill also provides that if the owners of a foreign corporation are treaty shopping (as defined above), a treaty that prohibits U.S. taxation of interest paid by a foreign corporation is to be overridden. In these cases, however, the committee intends to respect any treaty relationship that the interest recipient has with the United States in determining the applicable tax rate for the interest payments. Otherwise, the payments are subject to tax at a 30-percent rate if the recipient is not resident of a treaty country. For example, if a corporation organized in a foreign country has a branch in the United States and the foreign country has an income tax treaty with the United States that prohibits the United States from imposing a tax on interest payments made by the foreign corporation, the treaty provision will be respected if the owners of the foreign

corporation are not treaty shopping. If the owners are treaty shopping, then the United States will impose its 30 percent withholding tax on U.S. source interest payments made by the corporation, unless a treaty between the United States and the recipients' country of residence otherwise reduces or eliminates the tax and no treaty shopping with respect to the latter treaty takes place..

Effective Date

The provision is effective for taxable years beginning after December 31, 1986.

For U.S. branches of foreign corporations that have undistributed accumulated earnings and profits as of their first taxable years beginning on or after January 1, 1987, the bill's provisions are to apply to income generated in taxable years after December 31, 1986, that are considered distributed from the branch to the home office, limited by post-effective date earnings and profits. Meanwhile, present law's second-level withholding tax on dividends is to apply to the pre-effective date accumulated earnings and profits that are distributed after the effective date. Thus, if a branch's income had not constituted at least 50 percent of the corporation's income for the base period prescribed under present law, there would be no withholding tax imposed.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $13 million in 1987, $20 million in 1988, $23 million in 1989, $26 million in 1990, and $28 million in 1991.

2. Retain Character of Effectively Connected Income (sec. 953 of the bill and sec. 864 of the Code)

Present Law

The United States taxes the worldwide income of U.S. citizens, residents, and corporations on a net basis at graduated rates. Nonresident aliens and foreign corporations are generally taxed only on their U.S. source income. The United States taxes foreign taxpayers' income that is "effectively connected" with a U.S. trade or business on a net basis at graduated rates, in much the same way that it taxes the income of U.S. persons. U.S. income of a foreign taxpayer that is not connected with a U.S. trade or business is generally subject to a 30-percent withholding tax on the gross amount of such income, although certain types of such income earned by foreign investors, such as portfolio interest income, are exempt from U.S. tax. U.S. income tax treaties reduce or eliminate the 30-percent withholding tax in many cases. The United States does not generally tax foreign taxpayers on capital gains that are not connected with a U.S. trade or business (real property gains have been the major exception to this rule).

Although gains from the sale of assets used by a foreign corporation in a U.S. trade or business ordinarily would constitute effectively connected income fully subject to U.S. tax, under present law foreign persons may be able to avoid U.S. tax on income attributable to a U.S. trade or business if they receive the income in a year

after the trade or business has ceased to exist (e.g., by selling property and recognizing the gain on the installment basis). Foreign persons may also be able to avoid U.S. tax by removing property of a trade or business from the United States before selling it.

Reasons for Change

Under present law foreign taxpayers can avoid U.S. tax by receiving income that was earned by a U.S. trade or business in a year after the trade or business has ceased to exist. For example, the business can sell property and accept an installment obligation as payment. By recognizing the gain on the installment basis, the taxpayer can defer the income to a later taxable year. If the taxpayer had no U.S. trade or business in that year, then the income recognized in that year is not treated as effectively connected with a U.S. trade or business. The committee believes that income earned by a foreign person's U.S. trade or business should be taxed as such, regardless of whether recognition of that income is deferred until a later taxable year. Similarly, the committee believes that foreign persons should not be able to avoid U.S. tax on their income from the performance of services in the United States where payment of the income is deferred until a subsequent year in which the individual is not present in the United States. Finally, the committee likewise believes that gains accrued by a foreign person's U.S. trade or business should be subject to U.S. tax, and that such tax should not be avoidable through the simple expedient of removing property from the country prior to its sale. The committee recognizes that U.S. persons that transfer assets out of U.S. tax jurisdiction may be subject to tax on unrealized appreciation (sec. 367). The committee believes a similar rule is appropriate for foreign persons as well.

Explanation of Provision

The bill amends section 864(c) to provide that any income or gain of a foreign person for any taxable year which is attributable to a transaction in any other taxable year will be treated as effectively connected with the conduct of a U.S. trade or business if it would have been so treated if it had been taken into account in that other taxable year. Thus, deferring the recognition of income until a later taxable year will no longer change the manner in which the U.S. tax system treats the income.

In addition, the bill provides that the removal from U.S. tax jurisdiction of the assets of a foreign person's U.S. trade or business will be treated for U.S. tax purposes as a taxable disposition of those assets. Removal of business assets occurs by physical departure from the United States. Removal also occurs by disposition within the United States after the trade or business has ended.

For example, assume foreign individual I owns foreign corporation C, which uses the calendar year as its fiscal year. C owns business property physically located in the United States. C ceases U.S. business activity in the United States at the end of 1987. Disregarding any effect of the new rule provided by this provision of the bill, if C had sold its property at a gain in 1987, the gain would have been effectively connected with a U.S. trade or business, but if C

had sold the property in 1989, the gain would not have been so connected, due to the cessation of U.S. business activities by C prior to the beginning of 1988. Under section 953 of the bill, if C sells the property in 1989, any gain would be characterized as effectively connected. If C completely liquidates in 1989 and transfers its property to I, its sole shareholder, section 953 of the bill would cause the disposition of the property to be treated as a taxable dispostion by C notwithstanding the nonrecognition provisions of Code Section 336, and would characterize any gains as effectively connected with a U.S. trade or business. On the other hand, if C completely liquidated and transferred its property to I in 1987, without previously terminating its U.S. trade or business, the nonrecognition provisions of Section 336 would not be overriden because the transfer in liquidation would not be treated as a removal from U.S. tax jurisdiction. Note that in this latter case, the assets would remain within U.S. tax jurisdiction as property producing effectively connected income for I.

Because the provision is intended to tax only gain that accrues while property is within the United States, property brought into the United States will be deemed to have a basis equal to its fair market value on the date that it was brought into the country. This special basis rule applies solely for purposes of determining the amount of gain required to be recognized upon the removal of the asset, and not for any other purpose of the Code (*e.g.*, depreciation).

Effective Date

The provision applies to taxable years beginning after 1986.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by less than $5 million per year.

3. Tax-Free Exchanges by Expatriates (sec. 954 of the bill and sec. 877 of the Code)

Present Law

A U.S. citizen who gives up citizenship for a principal purpose of avoiding U.S. tax will, for ten years, continue to be taxed as a citizen on U.S. source income, but not foreign source income, under Code section 877. U.S. income of such tax-avoidance expatriates will thus be subject to tax on a net basis at graduated rates, regardless of how such income would be taxed to a nonresident alien. U.S. income for this purpose includes gains from sales of U.S. property (i.e., property located in the United States, stock of U.S. corporations, and debt obligations issued by any U.S. person, including Federal, state and local governments).

Reasons for Change

Tax-avoidance expatriates may under present law be able to avoid U.S. tax by making a tax-free exchange of U.S. property for foreign property. The sale of the U.S. property would be subject to

U.S. tax, but the sale of the foreign property would not be. The committee believes that expatriates should not be permitted to accomplish indirectly that which they are prohibited from doing directly.

Explanation of Provision

The bill amends section 877 to provide that gain on the sale or exchange of property whose basis is determined in whole or in part by reference to the basis of U.S. property will be treated as gain from the sale of U.S. property. Thus, expatriates will still be permitted to make tax-free exchanges of U.S. property for foreign property. However, a subsequent disposition of that foreign property (on which gain is recognized) will be treated as a disposition of U.S. property, and will therefore be subject to U.S. tax.

Effective Date

The provision applies to dispositions of property acquired in tax-free exchanges after March 1, 1986.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by a negligible amount.

4. Study of Competitive Effect on U.S. Reinsurers of U.S. Tax Treaty Exemptions for Foreign Insurers and Reinsurers (sec. 955 of the bill)

Present Law

U.S. reinsurers, like other U.S. persons, are generally taxed on a net basis on their worldwide income.

Foreign reinsurers generally are subject to U.S. income tax on income derived from the reinsurance of risks located in the United States in situations where that reinsurance income is effectively connected with a U.S. trade or business. However, foreign reinsurers reinsuring U.S. risks ordinarily will not be viewed as conducting a U.S. trade or business and thus will not be subject to U.S. income tax if they have no U.S. office or agent. U.S. income tax treaties may further limit the circumstances in which foreign reinsurers are subject to U.S. income tax.

When a foreign reinsurer is not subject to U.S. income tax, an excise tax is imposed on each policy of insurance, indemnity bond, annuity contract, or policy of reinsurance issued by the foreign reinsurer to, or for, or in the name of a domestic corporation or partnership, or a U.S. resident individual with respect to risks wholly or partly within the United States, or to, or for, or in the name of any foreign person engaged in business within the United States with respect to risks within the United States (Code sec. 4371). The excise tax is imposed at the rate of (1) 4 cents on each dollar (or fraction thereof) of the premium paid on a policy of casualty insurance or indemnity bond; (2) 1 cent on each dollar (or fraction thereof) of the premium paid on a policy of a life, sickness, or accident insurance, or annuity contract on the life or hazards to the person

of a U.S. citizen or resident, unless the insurer is subject to U.S. tax subject to the adjustments under Code section 813 (relating to the taxation of foreign life insurance companies); and (3) 1 cent on each dollar (or fraction thereof) of the premium paid on a policy of reinsurance covering any of the contracts taxable under (1) or (2).

Present law provides exemptions from the excise tax in the case of (1) policies signed or countersigned by an officer or agent of the insurer in a State or the District of Columbia, within which such insurer is authorized to do business, or (2) any indemnity bond required to be filed by any person to secure payment of any pension, allowance, allotment, relief, or insurance by the United States, or to secure a duplicate for, or the payment of, any bond, note, certificate of indebtedness, war-saving certificate, warrant, or check issued by the United States (Code sec. 4373).

The excise tax also may be waived in certain cases under certain recent U.S. tax treaties, such as it is in the United States-Barbados Income Tax Treaty, the United States-Cyprus Income Tax Treaty, the United States-United Kingdom Income Tax Treaty and the United States-France Income Tax Treaty. Although premiums received by certain persons may be exempt from the excise tax (whether by treaty or by statutory exception), such exceptions generally do not waive the excise tax for subsequent reinsurance transactions covering insurance of U.S. risks under which premiums are paid to and received by a nonexempt person.

Reasons for Change

The committee is concerned that U.S. reinsurers may be at a competitive disadvantage vis a vis foreign reinsurers of U.S. risks as a result of the disparate U.S. tax treatment of U.S. and foreign reinsurers. While U.S. reinsurers are subject to U.S. tax on their worldwide income, foreign reinsurers are frequently not taxed by the United States on income attributable to the reinsurance of U.S. risks. The excise tax on insurance premiums paid to foreign reinsurers operates to mitigate this inequality of treatment in some cases. However, many foreign reinsurers of U.S. risks are exempt from this excise tax under U.S. treaties. If U.S. reinsurers are at a significant competitive disadvantage vis a vis foreign reinsurers of U.S. risks as a result of these treaty exemptions, the committee may consider legislation directing the Secretary of the Treasury to renegotiate the treaties in question to eliminate that disadvantage.

Explanation of Provision

The bill requires the Secretary of the Treasury or his delegate to conduct a study to determine whether U.S. reinsurance corporations are placed at a significant competitive disadvantage vis a vis foreign reinsurance corporations by reason of existing treaties between the United States and foreign countries, specifically identifying any treaties that create a significant competitive disadvantage. The Secretary is to report the results of this study to the Senate Committees on Finance and Foreign Relations and the House Committees on Ways and Means and Foreign Affairs before January 1, 1988. If the study indicates that U.S. reinsurance corporations are at such a competitive disadvantage, the committee be-

lieves that the Secretary of the Treasury should renegotiate the relevant treaties to eliminate that disadvantage.

Effective Date

This provision is effective on the date of enactment.

Revenue Effect

This provision is estimated to have a negligible effect on budget receipts.

5. Reporting by Foreign Controlled Corporations (sec. 986(c) of the bill and sec. 6038A of the Code)

Present Law

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) added new reporting requirements under section 6038A for certain foreign-controlled corporations. In general, these requirements apply both to U.S. corporations and to foreign corporations engaged in trade or business in the United States ("reporting corporations"), but only if they are controlled by a foreign person (defined to include certain possessions residents). This control test requires reporting if at any time during a taxable year a foreign person owns 50 percent or more of the stock of the reporting corporation (either by value or by voting power).

The reporting corporation must furnish certain information about any corporation that (1) is a member of the same "controlled group" as the reporting corporation (a group that generally includes brother-sister corporations as well as the reporting corporation's parent and subsidiaries)[1] and that (2) has any transaction with the reporting corporation during the taxable year. The information that the reporting company is to report is such information as the Secretary may require that relates to the related company's name, its principal place of business, the nature of its business, the country in which it is organized and in which it is resident, its relationship with the reporting corporation, and its transactions with the reporting corporation during the year.

Reasons for Change

The committee believes that the reporting requirements of section 6038A should be extended to apply to transactions with related persons other than corporations.

Transactions between related persons can often be manipulated by foreign taxpayers to avoid U.S. tax. For example, the foreign owners of a U.S. corporation may attempt to reduce the U.S. corporation's taxable income by selling it property at unrealistically

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[1] For the purpose of the reporting requirement, the term "controlled group" incorporates the definition of controlled group of corporations in section 1563(a) with certain changes in the percentage tests of that section and with certain exceptions. Although under section 1563(b) foreign corporations subject to tax under section 881 and certain other corporations are "excluded members" of a controlled group rather than "component members" for the purpose of section 1561, the exclusion of these corporations from the definition of "component members" for that purpose does not remove them from the controlled group, as defined in section 1563(a). Therefore, TEFRA requires reporting about any foreign corporation that otherwise qualifies as a member of the controlled group.

high prices. Such owners may be individuals, corporations, or other legal entities. Congress added the reporting requirements of section 6038A to help the IRS obtain sufficient information to detect and challenge such abusive transactions. However, these requirements as presently stated are too narrow. A corporation subject to section 6038A is only required to report with respect to its transactions with other corporations in the same controlled group; no reporting is required with respect to other related foreign persons that are not corporations, such as partnerships, trusts, and individuals. The committee believes that transactions with noncorporate related persons, like transactions with related corporations, may be subject to transfer pricing and other abuses, and, therefore, that similar reporting requirements should apply to transactions with noncorporate related persons. The absence of parallel reporting rules may encourage taxpayers to include noncorporate related persons in their chain of ownership, so as to defeat the intended operation of section 6038A.

Explanation of Provision

Under the bill, a corporation subject to the reporting requirements of section 6038A must report with respect to its transactions with all related persons (within the meaning of Code section 482), not merely its transactions with corporations in its controlled group.

Effective Date

The amendment applies to taxable years beginning after December 31, 1986.

Revenue Effect

The amendment is estimated to increase fiscal year budget receipts by less than $5 million annually.

6. Foreign Investors in U.S. Partnerships (sec. 985 of the bill and secs. 864, 871, 875, 881, 882, 1441, and 1442, and new sec. 1446 of the Code)

Present Law

Foreign persons receiving U.S. source income are in a number of cases subject to withholding of U.S. tax by the payor of that income. As a general rule, withholding is required with respect to passive income received by foreign investors who have limited contacts with the United States and from whom it would otherwise be difficult to collect tax. On the other hand, withholding is generally not required with respect to income that foreign persons earn through the active conduct of a trade or business in the United States, since such persons generally have a substantial presence in the United States. If a foreign person invests in the United States through a partnership, the withholding rules that apply to distributions by the partnership are determined by reference to the types of income earned by the partnership. If the income earned by the partnership would not be subject to withholding if earned directly

by a foreign person (i.e., income earned through the active conduct of a trade or business), then no withholding is imposed when that income is earned and distributed through a partnership.

Reasons for Change

The committee is concerned that the present structure of withholding rules applicable to foreign persons who invest in the United States through partnerships may permit passive investors to escape U.S. taxation on their income. Foreign persons who buy U.S. partnership interests frequently do so as portfolio investments, representing the functional equivalent of stock investments. In fact, interests in a number of U.S. partnerships are publicly traded on stock markets in a manner indistinguishable from corporate stock. These types of partnership investments ordinarily do not represent the type of substantial and continuing U.S. presence that justifies the absence of a withholding requirement. The committee does not believe that a partnership's conduct of a U.S. trade or business provides any assurance that its foreign partners will comply with U.S. tax laws. In these cases, the investors are required to file U.S. tax returns and pay U.S. tax, but if they fail to do so the IRS is likely to find it nearly impossible to locate them and collect the tax. Therefore, the committee believes that all effectively connected income earned by foreign persons through U.S. partnerships should be subject to U.S. withholding tax to ensure collection of such persons' U.S. income tax liability.

Explanation of Provision

The bill provides that the following withholding rules will apply to distributions to foreign partners in U.S. partnerships that have income effectively connected with the conduct of a U.S. trade or business. First, present law rules requiring withholding at 30 percent (or reduced treaty rates) with respect to distributions attributable to dividends, certain interest, etc., will continue to apply to such distributions. However, the bill specifies that any distribution by the partnership is considered to come first out of these types of income received by partnerships. Second, the remaining partnership distributions are subject to withholding at a 20 percent rate. The amount withheld is creditable against the U.S. income tax liability of the foreign partner. Third, where interests in a publicly traded partnership are held through one or more nominees, withholding is to be carried out under the principles of section 1441(a) by the last U.S. person in the chain of ownership.

The Secretary may by regulations provide for exceptions to this withholding requirement in cases where withholding is not necessary to ensure compliance with U.S. tax laws. The bill provides that, unless otherwise provided in regulations, withholding is not required if substantially all of the U.S. source income of a partnership is allocable to U.S. partners pursuant to a valid special allocation under section 704(b) and regulations thereunder.

Effective Date

The provision applies to taxable years of domestic partnerships beginning after December 31, 1986.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by less than $5 million per year.

7. Income of Foreign Governments and International Organizations (sec. 982 of the bill and sec. 892 of the Code)

Present Law

The income of foreign governments or international organizations received from investments in the United States in stocks, bonds, or other domestic securities, owned by such foreign governments or international organizations, or from interest on deposits in banks in the United States of money belonging to such foreign governments or international organizations, or from any other source within the United States, is not included in gross income and is exempt from U.S. income taxation (sec. 892). Regulations make clear that this exemption does not apply to any income from commercial activities in the United States (Reg. sec. 1.892-1(a)(3)). That is, the exemption extends only to investment income.

Under regulations, the exemption for investment income extends to integral parts of a foreign government such as agencies and bureaus, so long as the earnings of these parts of a government are credited to their own accounts or to other accounts of the foreign government, with no portion inuring to the benefit of any private person (Reg. sec. 1.892-1(b)). In addition, regulations generally extend the exemption for investment income to entities (such as corporations) which are separate in form from a foreign government if they are wholly owned and controlled by the foreign government directly or indirectly, if all their earnings currently or eventually benefit the foreign government and no private persons (*id.*). Regulations also provide that the exemption extends to certain pension trusts benefitting government employees or foreign employees and to political subdivisions of foreign countries (*id.*).

Regulations specify that commercial activities, for this purpose, do not include investments in the United States in stocks (whether or not a controlling interest investment), bonds, or other securities, loans, net leases on real property, or the holding of deposits in banks (Reg. sec. 1.892-1(c)). The regulations specify, in addition, that an activity will not cease to be an investment solely because of the volume of transactions of that activity or because of other unrelated activities (*id.*). Performances and exhibitions within the United States of amateur athletic events and events devoted to the promotion of the arts by cultural organizations are not commercial activities (*id.*).

Similar rules apply to income of international organizations.

A separate exemption applies to certain income of foreign central banks of issue (sec. 895). A further exemption applies to certain income of employees of foreign governments (sec. 893).

Some U.S. income tax treaties specifically cover some income earned by governments. In other cases, the provisions of an income tax treaty with a foreign country do not appear to grant U.S. tax relief to that foreign country when it is subject to U.S. tax. Some recent treaties generally allow protection only to "residents" of the treaty partner country. A typical definition of "resident" of a country for treaty purposes is "any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, citizenship, place of management, place of incorporation, or any other criterion of a similar nature..." (Treasury Deparment's Model Income Tax Treaty of June 18, 1981, Article 4). Under this definition, treaty protection for a foreign government might seem to turn, for instance, on whether it is liable to its own tax.

Some form of exemption for income of foreign governments has been in the U.S. tax law since 1917. A 1920 ruling distinguished between income earned by a foreign ruler "in his individual capacity", which was taxable, and income earned on property "belonging to the crown", which was not taxable. O.D. 483, 2 C.B. 96 (1920), *declared obsolete*, Rev. Rul. 70-293, 1970-1 C.B. 282. There has been some confusion about the extent of the exemption.[2]

Reasons for Change

The committee's examination of current law's tax exemption for investment income of foreign governments has revealed several problems. First, the exemption extends to entities, even business corporations, wholly owned by foreign governments. This treatment tends to favor, for example, nationalized industries over privately owned industries. Under current law, the United States taxes U.S. source investment income received by a privately-owned foreign business corporation but not similar income received by a state-owned business corporation. The committee does not believe that this difference in treatment is appropriate.

Second, current law provides an exemption for income (such as interest and dividends) derived by foreign governments or governmental entities from U.S. businesses that they control. For example, a foreign government may buy a controlling interest in a U.S. corporation. Dividend and interest payments from that corporation to the foreign government escape U.S. shareholder level tax. While an exemption for income from passive investments may be appropriate in some cases, payments to a controlling entity, in the committee's view, are in the nature of a return on a direct investment, not on a portfolio investment. These payments, in the committee's view, are not passive investment income. The committee does not believe that exemption is appropriate in this case.

In connection with its decision to limit the tax exemption for foreign governments, the committee addressed the issue whether governments are entitled to tax treaty benefits, such as those that extend to persons liable to tax in a foreign country. Whether a foreign government is liable to pay tax to itself on its income seems to be a meaningless question. It does not appear that U.S. tax exemp-

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[2] *See* Tillinghast, "Sovereign Immunity from the Tax Collector; United States Income Taxation of Foreign Governments and International Organizations," 10 *Law and Policy in International Business*, 495, 503 (1978).

tion to a foreign government that is a treaty partner should depend, for instance, on its internal sovereign immunity laws. The committee sees no reason to treat a foreign government worse than comparable private investors from the government's country. Therefore, the committee believes it appropriate to treat foreign countries as residents of themselves for applying treaty rules to this provision of the bill, so long as the country at issue does not deny similar treatment to the United States.

Explanation of Provision

The bill codifies the rule limiting the tax exemption for foreign governments to investment income. The bill defines commercial activity to include ownership of a controlling interest in a corporation or other entity engaged in trade or business in the United States. For this purpose, controlling interest means an interest of 50 percent or more, by vote or value, in a U.S. corporation or other entity, or any other interest that allows or would allow the exercise of effective control. For this purpose, there is aggregation of commonly owned interests.

For example, a foreign government owns 50 percent of a U.S. corporation. Under the bill, dividends paid by the U.S. corporation to the foreign government will be subject to tax on a gross withholding basis. The rate of tax will be 30 percent, unless reduced by treaty. Similarly, gross interest payments from the U.S. corporation to the foreign governmental shareholder (or a related party) will be subject to a 30-percent withholding tax (or tax at a lower treaty rate). Interest payments to a related party such as a 50-percent shareholder are not exempt from U.S. tax (because they are not portfolio interest as defined in section 871).

The foreign government exception will not apply to controlled entities that engage in any commercial activities anywhere. For example, an incidental loan into the United States by a bank, wholly owned by a foreign government, might not in and of itself constitute commercial activity in the United States. Assume that the interest does not qualify as portfolio interest, and that the U.S. tax on that interest is not eliminated by treaty. Interest on that loan would be subject to tax under the bill, because the foreign entity, though not engaged in a U.S. trade or business, is engaged in the business elsewhere.

Once a foreign governmental entity is found to engage in commercial activity somewhere in the world, the United States must determine whether to impose its tax on any particular U.S. source income of that entity on a net basis or a gross basis. For this purpose, in general, the committee intends that the principles distinguishing income taxed on a net basis and income taxed on a gross basis for private foreign persons apply to foreign governments also. For example, assume that a foreign government owns an airline. The airline does not fly to or from the United States, and it is not otherwise engaged in the conduct of a trade or business in the United States. The airline purchases 2 percent of the stock of a U.S. airline corporation. Dividends paid with respect to that stock are taxable on a gross basis, at the 30-percent or lower treaty rate, because they are not effectively connected with the conduct of a

U.S. trade or business. If, by contrast, a foreign governmental entity owns stock in a U.S. corporation that pays dividends yielding effectively connected income in the hands of a comparable privately owned corporation, those dividends will be subject to U.S. tax on a net basis.

The committee does not believe that income derived by foreign governments' athletic teams and cultural groups should be treated differently from similar income earned by privately-owned foreign professional teams or groups. That income is not in the nature of investment income. In such a case, if a treaty prevents U.S. taxation, or if the team comes on a nonprofit basis, there will be no tax.

The committee intends that, for treaty purposes, a foreign government be treated as a resident of its country, unless it denies treaty benefits to the United States. The committee intends that similar treatment apply to agencies and bureaus of foreign governments, and to corporations owned by foreign governments that are residents of its country under the treaty, so long as the country does not deny reciprocal treatment to comparable U.S. entities.

Effective Date

This provision is effective for income earned in taxable years beginning after 1986.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $23 million in 1987, $43 million in 1988, $48 million in 1989, $53 million in 1990, and $58 million in 1991.

8. Transfer Prices for Imports (sec. 981 of the bill and sec. 1059A of the Code)

Present Law

When a U.S. taxable entity imports goods to the United States for resale or use in its business, there may be an incentive to state a high price for the goods, thus reducing U.S. taxable income, particularly when the goods are purchased from a related foreign party that is not subject to U.S. tax. On the other hand, if imported goods are subject to a tariff or other import duty, there is an incentive to state a low value for U.S. customs purposes.

The Secretary of the Treasury is authorized to allocate income between commonly controlled entities as necessary to prevent evasion of taxes or clearly to reflect income (sec. 482). Treasury regulations prescribe a reallocation of income where the price charged between such commonly controlled entities is not arm's length. There are frequently questions of fact regarding what constitutes an arm's length price for goods.

Reasons for Change

The committee understands that some importers may claim a transfer price for income tax purposes that is too high to be consistent with the transfer price claimed for customs purposes. *See*

Robert M. Brittingham, 66 T.C. 373 (1976); aff'd 598 F.2d 1375 (5th Cir. 1979).

The committee is particularly concerned that such practices between commonly controlled entities may improperly avoid U.S. tax. Changes in U.S. customs laws after the 1979 Tokyo Round now generally make transactions-based pricing the rule for customs purposes.

Explanation of Provision

The bill provides that importers subject to U.S. tax may not claim a transfer price for U.S. income tax purposes that is higher than would be consistent with the value they claim for customs purposes. Appropriate adjustments may be made in applying the rule in cases where customs pricing rules differ from appropriate tax rules—as, for example, with the inclusion or exclusion of freight charges. This rule applies to transfer prices between commonly controlled entities, as defined in section 482 of the Code.

Effective Date

The provision applies to transactions entered into after March 18, 1986.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by less than $5 million annually.

9. Dual Resident Companies (sec. 983 of the bill and sec. 1504 of the Code)

Present law

A corporation that is created or organized in the United States or under the laws of the United States or of any State is a "U.S. corporation." (U.S. corporations are sometimes referred to a U.S. resident corporations.) The United States taxes every U.S. corporation on its worldwide income (with allowance of a foreign tax credit), and allows it to deduct losses wherever incurred. The United States allows U.S. corporations to file consolidated tax returns with other U.S. corporations that are commonly owned. When two or more U.S. corporations file a consolidated return, losses that one corporation incurs may reduce or eliminate tax on income that another corporation earns.

Some countries use criteria other than place of incorporation to determine whether corporations are residents for their tax purposes. In particular, some countries, including the United Kingdom and Australia, treat corporations as domestic residents if they are managed or controlled there. If one of these two foreign countries determines a corporation to be its resident, that foreign country typically taxes it on its worldwide income and allows it to deduct losses wherever incurred. In some cases, these two foreign countries allow losses of a resident corporation to reduce or eliminate tax on income of commonly owned corporations.

For tax purposes, a corporation may be at the same time a U.S. resident and a resident of another country. Such companies are sometimes refered to as "dual resident companies." A dual resident company is taxable in both countries on its worldwide income (or it can deduct its worldwide losses). In addition, if the company is a resident of both the United States and either the United Kingdom or Australia, it is able, in effect, to use its losses to offset the income of commonly owned corporate residents in the two countries. (The committee is aware of the ability to share losses in this way only in the case of Australia and the United Kingdm; this ability may occur in other cases as well.) In general, neither of these countries taxes the active business income of foreign corporations that operate solely abroad.

Corporate groups attempt to isolate expenses in dual resident companies so that, viewed in isolation, the dual resident company is losing money for tax purposes. This isolation of expenses allows, in effect, the consolidation of tax results of one money-losing dual resident corporation with two profitable companies, one in each of two countries. This use of one deduction by two different corporate groups is sometimes referred to as "double dipping." The profitable companies report their income to only one country.

Reasons for Change

Losses that a corporation uses to offset foreign tax on income that the United States does not subject to tax should not also be used to reduce any other corporation's U.S. tax. Disallowing such losses will allow foreign and U.S. investors to compete in the U.S. economy under tax rules that put them in the same competitive position. By allowing "double dipping" (use of a deduction by two different groups), the current treatment of dual resident companies gives an undue tax advantage to certain foreign investors that make U.S. investments. The committee believes that elimination of double dipping for foreign-owned businesses will tend to put U.S.-owned and foreign-owned businesses on a competitive par. The committee does not believe that leveling the playing field for U.S.-owned and foreign-owned businesses violates any U.S. treaty obligation requiring the United States not to discriminate against foreign-owned businesses. In fact, denial of double dipping to foreign-owned businesses that operate in the United States is necessary to end U.S. discrimination against U.S.-owned businesses that operate in the United States.

For example, under current law, a profitable U.K. company may acquire a profitable U.S. target by establishing a dual resident holding company to own the shares of the U.S. target. The dual resident company borrows funds with which to buy the target. The interest expense of the dual resident company appears on both the U.K. and the U.S. returns. It is conceivable that a company could have worldwide profits from operating in just two countries, the United Kingdom and the United States, yet, by using the dual resident company device, pay no current taxes to either country.

As an example, assume that a U.K. corporation earns $100 of income before purchasing a U.S. target. The target produces $100 of income. To finance the purchase of the target, the U.K. corpora-

tion establishes a dual resident company that incurs interest expense of $100. The dual resident company effectively shares its loss with its U.K. parent, so the group's U.K. taxable income shrinks from $100 to 0. In the United States, the dual resident company consolidates with its subsidiary, the U.S. target, so U.S. taxable income is zero. Despite worldwide profits of $100, earned solely in the United States and the United Kingdom, the group owes no current tax to any country.[3]

In the example above, the U.K. corporation reduced its U.K. tax on U.K. income (and its worldwide tax on worldwide income) by making the investment in the United States through the dual resident company device. That is, the marginal tax rate on that investment was negative. That result occurred even though the target's income exactly offset the expenses of financing the acquisition. By contrast, if a similar U.S. corporation bought the same U.S. target corporation through the use of the same amount of debt, it would not reduce its tax. For example, assume that a U.S. corporation earns $100 of income before purchasing a U.S. target. The target produces $100 of income. To finance the purchase of the target, the U.S. corporation establishes a holding company that incurs interest expense of $100. The holding company effectively shares its loss with the other members of the U.S. group, but the group's taxable income remains at $100. There is no reduction of the group's total tax liability, as there is when a U.K. corporation buys a U.S. corporation through the use of the dual resident corporation device. The committee believes that the dual resident company device creates an undue incentive for U.K. corporations (and Australian corporations) to acquire U.S. corporations and otherwise to gain an advantage in competing in the U.S. economy against U.S. corporations.

Some taxpayers have argued that the United States should not pay attention to the tax treatment that foreign countries apply to U.S. corporations. In particular, they argue that U.S. tax results should not turn on whether foreign countries allow U.S. corporations to share losses with affiliates. The United States frequently takes foreign taxation into account, however. In particular, in allowing a foreign tax credit, the United States carefully considers the tax systems of foreign countries. (In allowing a deemed-paid foreign tax credit, the United States even allows foreign tax treatment of foreign corporations to operate to reduce the U.S. tax obligations of U.S. corporations.)

Explanation of Provision

The bill provides that, except as provided in regulations, a U.S. corporation may not be a member of a U.S. consolidated group for a year in which, in another country, it consolidates with or otherwise transfers tax benefits to a related party all of whose earnings are not currently or eventually subject to U.S. tax. The statute allows the Secretary to impose consolidation, notwithstanding the bill's general rule, in cases where taxpayers use the general rule as a device to break consolidation.

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[3] See "Dollars at 0.2% After Tax? How a UK Company Did It Via a Dual-Residence Sub," *Business International Money Report*, December 20, 1985, 401.

Some treaties prohibit discrimination against foreign-owned enterprises that are "similar" to U.S.-owned enterprises. The committee has crafted this provision so that it does not violate treaties. First, it is not clear that a U.S. corporation that consolidates (or otherwise shares losses) with a foreign corporation and a U.S. corporation that does not consolidate with a foreign corporation are "similar enterprises" for treaty purposes. Second, the provision does not distinguish between corporations on the basis of their ownership, but instead on the basis of whether their losses allow foreign tax benefits to entities whose full earnings are or will be subject to U.S. tax. Finally, it is the committee's view that this prohibition of double dipping is in fact necessary to prevent discrimination in favor of foreign-owned businesses and against U.S.-owned businesses in the U.S. economy. If the committee should be incorrect in its technical interpretation of the interaction between this provision and treaties, however, it does not intend that any contrary provision defeat its elimination of this double dipping loophole. The committee does not believe that the United States Senate wittingly agreed to an international tax system where taxpayers making cross-border investments, and only those taxpayers, could reduce or eliminate their U.S. corporate tax through self-help and gain an advantage over U.S. persons who make similar investments.

Examples

The following examples illustrate the bill's operation.

Example 1.—A U.K. corporation owns a U.S.-U.K. dual resident corporation. The U.S.-U.K. dual resident company owns a U.S. subsidiary. The U.S.-U.K. dual resident company, a loss company, effectively transfers the U.K. tax benefit from its loss to its U.K. parent. Under the bill, the U.S.-U.K. dual resident company cannot consolidate in the United States with its U.S. parent, since the U.K. corporation's income will not be subject to U.S. tax.

Example 2.—A U.S. corporation owns a U.S.-U.K. dual resident corporation. The U.S.-U.K. dual resident company owns a U.K. subsidiary. The U.S.-U.K. dual resident company, a loss company, effectively transfers the U.K. tax benefit from its loss to its U.K. subsidiary. Under the bill, the U.S.-U.K. dual resident company can consolidate in the United States with its U.S. parent, since the U.K. corporation's income will be eventually subject to U.S. tax.

Example 3.—A U.K. corporation owns a U.S.-Australian dual resident corporation. The U.S.-Australian dual resident company owns a U.S. subsidiary and an Australian subsidiary. The U.S.-Australian dual resident company, a loss company, effectively transfers the Australian tax benefit from its loss to its Australian subsidiary. Under the bill, the U.S.-Australian dual resident company can consolidate in the United States with its U.S. subsidiary, because the income of the related company that benefitted from its loss will be eventually subject to U.S. tax.

Example 4.—A widely held U.S.-U.K. dual resident corporation owns a chain of U.S. subsidiaries, a chain of U.K. subsidiaries, and a number of third country corporations. The U.S.-U.K. dual resident company, the ultimate parent, is a loss company. It effectively transfers the U.K. tax benefit from its loss to its chain of U.K. sub-

sidiaries. Under the bill, regardless of who owns the U.S.-U.K. dual resident company, that dual resident company can consolidate in the United States with its U.S. subsidiaries, because the income of the related U.K. companies that benefitted from its loss will be subject to U.S. tax.

Example 5.—A U.S. corporation owns a U.K. corporation. The U.K. corporation owns a U.S.-U.K. dual resident corporation. The U.S.-U.K. dual resident company owns a U.S. subsidiary. The U.S.-U.K. dual resident company, a loss company, effectively transfers the U.K. tax benefit from its loss to its U.K. parent. Under the bill, the U.S.-U.K. dual resident company can consolidate in the United States with its U.S. subsidiary, because the income of the U.K. company will be subject to U.S. tax.

Example 6.—A U.K. corporation with a U.S. permanent establishment and U.K. operations owns a U.S.-U.K. dual resident corporation. The U.S.-U.K. dual resident company owns a U.S. subsidiary. The U.S.-U.K. dual resident company, a loss company, effectively transfers the U.K. tax benefit from its loss to its U.K. parent. Under the bill, the U.S.-U.K. dual resident company cannot consolidate in the United States with its U.S. subsidiary, because all the income of the U.K. parent will not be subject to U.S. tax.

Effective Date

This provision is effective for taxable years beginning after 1986.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $24 million in 1987, $41 million in 1988, $43 million in 1989, $46 million in 1990, and $49 million in 1991.

10. Earnings Stripping: Disallowance of Excessive Deductions for Interest Paid To Related Tax-Exempt Parties (sec. 984 of the bill and sec. 163 of the Code)

Present Law

In many cases, U.S. taxpayers are related to, and share common economic interests with, tax-exempt entities. For example, a U.S. corporation may be a wholly owned subsidiary of a foreign corporation that is not subject to U.S. tax. Similarly, the stock of a U.S. corporation may belong to one or more charitable organizations whose earnings are generally tax-exempt.

Interest expenses of a U.S. taxpayer are generally deductible, whether or not they inure to the benefit of a related party or a tax-exempt entity. (In general, only those individuals who itemize expenses may deduct interest expenses.) When a related tax-exempt person receives interest from a taxpayer, however, the Code contains rules to protect the U.S. tax base. In certain cases, entities that are generally tax-exempt (such as charities) must pay tax on interest received from 80-percent-owned corporations (sec. 512(b)(13)). In other cases, loans to taxpayers from related tax-exempt parties are effectively prohibited (sec. 4975). Under this provision, a corporation must pay a prohibitive tax should it borrow from a pension fund covering its employees.

In 1969, Congress authorized the Secretary of the Treasury to prescribe regulations to determine whether an interest in a corporation is stock or indebtedness for tax purposes. Among the factors the Secretary is to consider under this legislation are the ratio of debt to equity of the corporation, and the relationship between holdings of stock in the corporation and holdings of the interest in question. After issuing proposed regulations addressing this issue, the Treasury Department withdrew its regulations in 1983. No regulations attempting to distinguish stock from indebtedness are now in force.

The Code contains rules that generally prohibit or defer deductions for losses, interest, and other expenses that arise from related party transactions (secs. 267 and 707(b)). Moreover, related party transactions are generally closely scrutinized by the Internal Revenue Service and frequently are subject to various rules designed to prevent unwarranted shifting of income or other improper tax results (see, for example, secs. 482, 453(e), and 1239).

In 1984, Congress delayed deductions for original issue discount accrued but not paid to related foreign persons until the time of payment (sec. 163(e)(3)).

Reasons for Change

The committee believes, as a general matter, that it is appropriate to limit the deduction for interest that a taxable person pays or accrues to a tax-exempt entity whose economic interests coincide with those of the payor. To allow an unlimited deduction for such interest permits significant erosion of the tax base. Allowance of unlimited deductions permits an economic unit that consists of more than one legal entity to contract with itself at the expense of the government. The payment of deductible interest that is tax-free to a related party is sometimes referred to as "earnings stripping." When a U.S. corporation that is consistently profitable before substantial interest deductions pays interest to its tax-exempt foreign parent, those interest deductions may too greatly reduce (or even eliminate) U.S. tax on a source basis. Absent deductions for undue related party interest, the United States would collect both a corporate tax on the U.S. corporation's profits and, in most cases, an eventual withholding tax on dividends it pays to its parent. The committee believes that some limitation on the ability to "strip earnings" out of this country through interest payments in lieu of dividend distributions is appropriate. The committee believes that the uncertainty of present law (particularly the debt-equity issue) may allow taxpayers to take aggressive positions that inappropriately erode the U.S. tax base. The committee was not convinced that the case law dealing with the debt-equity issue is adequate to address its concerns.

Similar cases involving domestic taxation should receive similar treatment, in the committee's view. For example, if two unrelated U.S. charities each own half of a U.S. corporation, its interest payments to them are not includible in income. Therefore, the ability to strip earnings is present. The committee believes it is appropriate to limit that ability.

The distinction between debt and equity has been very difficult to articulate. The committee believes that the difficulties inherent in distinguishing debt from equity, and in effectively enforcing that distinction, may lead to undue freedom to manipulate the U.S. tax system. In general, rules distinguishing stock from indebtedness are necessary to preserve a corporate tax in addition to a shareholder tax. When the recipient of interest is tax exempt, moreover, the problem is more acute. The danger is not solely that income will escape tax at the corporate level, but that it will escape U.S. tax altogether. In the case of a foreign treaty-exempt related interest recipient, the interest income may or may not be subject to foreign tax.

To address the problem of stripping earnings by interest payments to related tax-exempt parties, the committee considered adopting debt-equity rules limited in their scope to earnings-stripping cases. The committee concluded that a limitation of interest deductions tied to taxable income is a more easily administered and practical response than a special debt-equity rule. The committee rejected a debt-equity approach because of the lack of success with that approach in recent history. In addition, the committee does not believe that, in the long run, appropriate debt-equity ratios differ among industries and entities less widely than appropriate ratios of interest expense to pre-interest deduction taxable income. Finally, a limitation tied to taxable income goes to the heart of the earnings-stripping question.

The committee understands that some taxpayers who do not consistently strip earnings will sometimes incur an amount of interest expense to tax-exempt related parties that is large in relation to pre-interest deduction taxable income. For instance, a bad year in a business cycle might reduce pre-interest deduction taxable income to the point where the limitation takes effect. In such cases, the committee believes it appropriate to allow carryforwards of denied interest deductions. This approach effectively allows averaging of annual results.

Explanation of Provision

The bill provides that certain interest paid or accrued to related, tax-exempt parties (other than ESOPs) is not deductible. This deduction denial applies to the extent that the excess (if any) of the payor's total interest expense over the payor's total interest income is greater than 50 percent of adjusted taxable income. Adjusted taxable income means taxable income computed without regard to either net interest expense or NOL carryovers. Under regulations, the denial of deductions also applies to interest on back-to-back loans that inures indirectly to the benefit of a related party.

For this purpose, a recipient is related to the payor of interest if the payor shares 50 percent or greater commonality of interests with the recipient.

An example illustrates how the bill nets interest expense for the purpose of the limitation. A U.S. subsidiary of a foreign corporation earns $100 of pre-interest deduction interest income and $100 of other pre-interest deduction income. It incurs $120 of interest expense to a related tax-exempt party. Net interest expense is $20.

After interest expense and interest income are netted to the extent possible, this $20 does not exceed $50, which is 50 percent of netted pre-interest deduction income ($100). The limitation does not apply to this taxpayer. Its taxable income is $80. If it had instead paid $160 of interest expense to a related tax-exempt party, the limitation would apply. Net interest expense of $60 exceeds 50 percent of $100, which is the amount of (post-netting) pre-interest deduction income. The deduction would be limited to $50, so taxable income would be $50.

An entity is tax-exempt for this purpose if no tax is imposed by the United States on interest paid to the entity by the taxpayer. That is, the bill determines whether an entity is tax exempt for this purpose on an item (of interest) by item basis. The bill does not treat as tax-exempt a person with respect to interest that is currently subject to U.S. tax, whether in its hands or in the hands of a shareholder. Thus, to the extent that the interest is currently included under section 951 in the gross income of a U.S. shareholder of a controlled foreign corporation that derived the income, the interest is not tax-exempt for this purpose. Therefore, in many cases, interest that a U.S. corporation pays to its wholly owned finance subsidiary located in the Netherlands Antilles generally will not be subject to the limitation rule of the bill. For example, a U.S. corporation pays $1,000 of the interest to its Netherlands Antilles subsidiary. The Antilles subsidiary pays $900 to unrelated foreign persons and retains $100. The $100 retained by the Antilles company is fully subject to current U.S. tax under the subpart F rules of the Code. Therefore, that $100 is not subject to the bill's rule because, while paid to a related person, it is not exempt from U.S. tax. The $900 is not subject to the bill's rule because it is paid to persons who, while tax-exempt, are not related to the payor. Therefore, the bill does not limit the payor's interest deduction in this case. A similar rule applies in the case of foreign personal holding company inclusions.

Similarly, in the case of a U.S. charity that receives or accrues interest from a related person, the bill's application turns on whether the charity is exempt with respect to that amount of interest. For example, a charity that owns 100 percent of a corporation must include interest paid by that corporation in taxable income (sec. 512(b)(13)). That interest, includible by the related charity, is deductible by the corporation under the bill. If, by contrast, a charity owns only 60 percent of a corporation, interest payments from the corporation to the charity are not includible in the income of the charity. The bill's deduction limitation rule applies to the interest payments in that latter case.

For this purpose, interest (that is not connected with a back-to-back loan rule) paid to unrelated parties will be fully deductible. Interest paid to unrelated parties will, however, count in the determination whether interest expenses exceed 50 percent of pre-interest deduction taxable income. For example, a U.S. subsidiary of a foreign corporation earns taxable income, before interest deductions, of $100. Therefore, 50 percent of its pre-interest deduction taxable income is $50. It pays $40 of interest to an unrelated lender. That $40 of interest is not connected with a back-to-back loan. In the same year, that U.S. subsidiary pays $25 of interest to

its foreign parent. Its total interest deductions are $65. The bill denies the deduction for $15 of related party interest expense, a denial of related party interest expense to the extent that interest expense exceeds 50 percent of pre-interest deduction taxable income. Thus, taxable income for the year is $50.

In the example above, if the U.S. subsidiary with $100 of pre-interest deduction taxable income had instead paid $60 of interest expense to an unrelated lender, if no back-to-back loan were present, and if it paid or accrued no other interest expense, the full deduction would be allowed, so taxable income would be $40. If a U.S. subsidiary with $100 of pre-interest deduction taxable income had incurred $65 of interest expense to its foreign parent, and no interest to any other party, then the bill would disallow $15 of the deduction, so taxable income would be $50. If a U.S. subsidiary with $100 of pre-interest deduction taxable income had incurred $40 of interest to its foreign parent, and no other interest expense during the year, the bill would not disallow any of the deduction, so taxable income would be $60.

If a treaty between the United States and any foreign country reduces the rate of U.S. tax imposed on interest that the taxpayer pays or accrues to a related entity, the entity is treated as tax-exempt to the extent of the same proportion of such interest as the treaty's rate reduction (from the 30-percent rate) bears to the 30-percent rate. For example, a U.S. corporation is a subsidiary of a Swiss parent corporation. Under the income tax treaty between the United States and Switzerland, interest payments are subject to a 5-percent gross withholding tax. Under the normal statutory scheme, interest payments to related parties are subject to a 30-percent gross withholding tax. The U.S. corporation, before interest deductions, has $100 of taxable income. It pays $80 of interest to its Swiss parent. That $80 interest payment is subject to a $4 withholding tax. First, the U.S. corporation may deduct $50 of the interest payment to its Swiss parent: to that extent, the interest deduction does not exceed half of pre-interest deduction taxable income. As for the remaining $30 of interest expense paid to its Swiss parent, the U.S. corporation may deduct the payment to the extent that it bears tax at the normal statutory rate. The $30 interest payment is subject to tax at one-sixth the normal rate (the ratio of 5 percent to 30 percent). That is, five sixths of the $30 interest payment is tax-exempt. Therefore, the taxpayer may deduct currently one sixth, or $5, of the $30 excess interest payment. Of that $30 excess, $25 is nondeductible currently, but may be carried forward, as described below. The U.S. corporation's taxable income for the year is $45.

Under current law, back-to-back loans that have no substance are collapsed. See Rev. Rul. 84-152, 1984-2 C.B. 381, and Rev. Rul. 84-153, 1984-2 C.B. 383. The bill specifically directs the Secretary to treat back-to-back loans through unrelated parties like direct loans to related parties. For example, a U.S. corporation borrows money from a Dutch bank that has borrowed money from the foreign parent corporation of the U.S. corporation. Interest payments to the Dutch bank, under the bill, are treated like payments to the foreign parent corporation. The Internal Revenue Service may require statements of U.S. taxpayers owned by foreign persons that

interest payments or accruals to unrelated parties that benefit from reduced treaty rates are not part of back-to-back loan arrangements.

The bill's limitation applies not only to payors that are U.S. corporations, but to any person subject to U.S. tax.

The committee intends that interest expenses not currently deductible by virtue of this provision be carried forward for use in future years. Excess interest deductions are to be carried forward indefinitely, but may not be carried back.

As an example, a U.S. subsidiary of a foreign corporation in year 1 has pre-interest deduction taxable income of $10, and pays $100 in interest expense to its foreign parent. In year 1, its interest deduction is limited to $5, one-half of pre-interest deduction taxable income. Its taxable income is $5. The U.S. corporation may carry forward the $95 of interest deduction that it could not use in the current year. If, in year 2, the U.S. corporation earns $400 of pre-interest deduction taxable income and pays $100 of interest to its foreign parent, the U.S. corporation may carry forward the unused $95 deduction from the first year. Therefore, in the second year, the U.S. corporation's taxable income is $205. The U.S. corporation is entitled to deduct the $100 of current interest payment as well as the $95 of excess interest from the prior year. In this case, the total amount of interest deducted, $195, does not exceed one-half of pre-interest taxable income in year 2.

If, in the immediately preceding example, all the facts were the same except that in year 2 the U.S. corporation earned $300 of pre-interest deduction taxable income instead of $400, its taxable income for year 2 would be $150, computed as follows. Pre-interest deduction taxable income for year 2 is $300; one-half of that amount is $150. The taxpayer would deduct the full $100 of current year interest expense. In addition, the taxpayer could deduct $50 of the $95 available for carryover from the first year. On these facts, the taxpayer would have $45 of excess interest expense available for carryover into the third year.

For this purpose, taxable income for a year is to be computed without regard to net operating loss carryforwards or carrybacks. For instance, if a taxpayer incurs a net operating loss of $100 in year 1, earns pre-interest deduction taxable income of $100 in year 2, and pays $60 of interest expense to a related tax-exempt party in year 2, only $50 of interest expense in year 2 is deductible, so taxable income (before NOL carryforward) is $50 in year 2. The carryforward eliminates taxable income in year 2. Similarly, a taxpayer earns $100 of pre-interest deduction taxable income in year 1, pays $60 of interest to a related party in year 1 (of which only $50 is currently deductible). That taxpayer incurs a $100 net operating loss in year 2. Under the bill no retroactive adjustment is made to the deduction in year 1. The NOL carryback eliminates taxable income in year 1. In each of those cases, the taxpayer has paid net U.S. tax of zero, has a $50 net operating loss to carry forward into year 3, and $10 of excess interest expense available for use in year 3.

In the case of corporations that form part of an affiliated group that consent to file a consolidated tax return, the limitation will apply on a consolidated group basis. For example, a foreign corpo-

ration owns a first-tier U.S. corporation which in turn owns a second-tier U.S. corporation. The two corporations are eligible to file a consolidated return for the year, and they do so. If the first-tier corporation earns no income for the year and pays $100 of interest to its foreign parent during the year, while the second-tier corporation, which earns $300 of income, pays no interest, neither corporation is subject to the rule of the bill.

The committee understands that the impact of this limitation may fall heavily on foreign-based multinational corporations. The committee does not believe that any disproportionate impact of this of this limitation on foreign-owned entities violates any treaty nondiscrimination provision. The provision generally applies across the board, to tax-exempt U.S. entities and tax-exempt foreigners. The one exception, for Employee Stock Ownership Plans (ESOPs), arises from an overriding concern to encourage workers to participate in ownership of their businesses.

Even if this limitation affects foreign-owned U.S. businesses more than other taxpayers, that result may occur because present U.S. tax laws have already largely solved this problem in the purely domestic context (*see, e.g.*, secs. 267, 4975, and 512(b)(13)). Some U.S. tax provisions affect only foreign-owned U.S. businesses, but the purpose of these provisions is to provide comparable treatment for these and other U.S. taxpayers. *See, e.g.*, Code sec. 6038A (reporting requirements only for foreign-owned corporations); Treas. Reg. sec. 1.882-5 (different interest allocation rules for U.S. branches of foreign corporations). In short, separate treatment does not necessarily discriminate against foreign-owned U.S. businesses. The committee believes that this limitation on earnings stripping does not discriminate, and it does not violate any U.S. treaty obligation. If the committee should be incorrect in its technical interpretation of the interaction between this provision and treaties, however, it does not intend that any contrary provision defeat its purpose in enacting this limitation.

Effective Date

This provision is effective for interest paid or accrued on or after January 1, 1987.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $12 million in 1987, $26 million in 1988, $27 million in 1989, $29 million in 1990, and $33 million in 1991.

11. Repeal of Foreign Investment in Real Property Tax Act of 1980 (sec. 952 of the bill and secs. 861, 862, 871, 882, 897, 1445, 6039C, and 6652(g) of the Code)

Present Law

In 1980, Congress adopted the Foreign Investment in Real Property Tax Act (FIRPTA). FIRPTA requires foreign persons who dispose of U.S. real property interests to pay tax on any gain realized on the disposition. The interests on whose disposition recognition

occurs include real estate and shares in certain corporations owning primarily real estate.

FIRPTA provided for enforcement of the tax on foreign persons through a system of information reporting designed to identify foreign owners of U.S. real property interests. To simplify the administration of FIRPTA and to insure collection of the tax imposed, Congress generally replaced the information reporting system with a withholding system in the Tax Reform Act of 1984. The 1984 Act generally imposes a withholding obligation when a U.S. real property interest is acquired from a foreign person.

Reasons for Change

The committee believes that FIRPTA is an undesirable impediment to foreign investment in U.S. real estate. Capital gains of foreign persons on the disposition of assets other than real property, such as bonds and listed securities, are not generally subject to U.S. tax while, under FIRPTA, real property capital gains are. The FIRPTA rules may reduce aggregate demand for U.S. real property and, therefore, lower its price to the disadvantage of prospective U.S. sellers. Accordingly, the committee believes that FIRPTA should be repealed prospectively.

Explanation of Provision

The bill prospectively repeals the provisions of the Code (secs. 897, 6039C, and 6652(g)) added by FIRPTA that subject nonresident aliens and foreign corporations to tax on gains from dispositions of U.S. real property interests, and impose information reporting requirements in connection with such dispositions. Under the bill, such gains will no longer be subject to U.S. income tax unless, as before FIRPTA, they are effectively connected with a U.S. business or are realized by a nonresident alien individual who was present in the United States 183 or more days during the year. (Section 953 of the bill, discussed above, broadens the definition of effectively connected income to include gains attributable to prior years transactions undertaken in connection with a U.S. business.) The bill also repeals the FIRPTA withholding provisions (sec. 1445) enacted in 1984, and makes other necessary conforming amendments.

With respect to the period prior to FIRPTA's repeal, the committee directs the Treasury Department to examine the treatment under FIRPTA of transfers of stock in U.S. real property holding companies between corporate subsidiaries of a common corporate parent and corporate subsidiaries which share common ownership through a partnership arrangement, and make recommendations thereon to the Committee on Finance and the Committee on Ways and Means by October 1, 1986.

Effective Date

The repeal of the FIRPTA provisions applies to dispositions after December 31, 1986, in taxable years ending after that date.

Revenue Effect

The repeal of the FIRPTA provisions is expected to reduce fiscal year budget receipts by $134 million in 1987, $236 million in 1988, $248 million in 1989, $263 million in 1990, and $273 million in 1991.

12. Application of Accumulated Earnings Tax and Personal Holding Company Tax to Foreign Corporations (sec. 926 of the bill and secs. 535 and 545 of the Code)

Present Law

The accumulated earnings tax is imposed on corporations that accumulate earnings beyond the reasonable needs of their businesses rather than distributing them to their shareholders. The personal holding company tax is imposed on certain corporations receiving defined forms of passive income. The taxes are imposed on accumulated taxable income and undistributed personal holding company income, respectively. Those amounts are calculated by making several adjustments to the regular taxable income of a corporation, including deductions for net capital gains (and certain capital losses). A deduction for net capital gains is granted because the corporate and individual tax rates on capital gains are approximately equal, and there is therefore little incentive to accumulate capital gains in a corporation.

Foreign corporations are generally subject to these taxes if they have any shareholders that would be subject to U.S. tax on a distribution from the corporation. In the case of a foreign corporation, only U.S. source income enters into the calculation of the accumulated earnings tax or personal holding company tax. However, net capital gains may be deducted from taxable income (thus reducing the accumulated earnings tax or personal holding company tax), even if the capital gain is not otherwise taken into account for U.S. tax purposes because it is not effectively connected with a U.S. trade or business. Thus, capital gains that are not subject to U.S. tax may nevertheless reduce the accumulated earnings tax or personal holding company tax. United States source capital gain income realized by a foreign corporation trading in stock, securities, or commodities for its own account is not considered effectively connected income.

Reasons for Change

A foreign corporation may be able to use the net capital gain deduction to avoid application of the accumulated earnings tax or personal holding company tax, even when the corporation accumulates substantial gains that are subject to no U.S. tax. In such a case the basis for the capital gain deduction—equivalency of corporate and individual tax rates—is absent, since the corporate tax rate on the gains is zero. Foreign or U.S. individuals could use such a corporation to accumulate, and defer U.S. taxation of, gains from investments in stock, securities, or commodities. The committee does not believe that taxpayers should be permitted to use such a device to avoid application of the accumulated earnings tax or personal holding company tax. Therefore, the committee has concluded that in the case of a foreign corporation a net capital gain de-

duction for accumulated earnings tax or personal holding company tax purposes should be allowed only with respect to gains that are taxed in the United States.

Explanation of Provision

The bill amends sections 535 and 545 to provide that the accumulated earnings tax or personal holding company tax applicable to a foreign corporation will be calculated by taking net capital gains into account only if they are effectively connected with the conduct of a U.S. trade or business. Gains which are exempt from U.S. tax under a treaty obligation of the United States will not be considered effectively connected for this purpose.

Effective Date

The provision applies to gains and losses realized on or after March 1, 1986.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by less than $5 million per year.

F. Taxation of Foreign Currency Exchange Rate Gains and Losses (sec. 961 of the bill and secs. 905, 1092, 1256, and new secs. 985-989 of the Code)

Present Law

Background

When a U.S. taxpayer uses foreign currency, gain or loss (referred to as "exchange gain or loss") may arise from fluctuations in the value of the foreign currency in relation to the U.S. dollar. This result obtains because foreign currency is treated as personal property, and not as equivalent to the U.S. dollar, for Federal income tax purposes.

The principal issues presented by foreign currency transactions relate to the timing of recognition, the character (capital or ordinary), and the geographic source (domestic or foreign) of exchange gains or losses. Another area of concern is the treatment of a U.S. taxpayer that operates abroad through a branch or a subsidiary corporation that keeps its books and records in a foreign currency; here, the issues relate to the method used to translate results recorded in a foreign currency into U.S. dollars.

Foreign currency transactions

Most of the rules for determining the Federal income tax consequences of foreign currency transactions are embodied in a series of court cases and revenue rulings issued by the Internal Revenue Service ("IRS"). Additional rules of limited application are provided by Treasury regulations and, in a few instances, statutory provisions.

Foreign exchange gain or loss can arise in the course of a trade or business or in connection with an investment transaction. Exchange gain or loss can also arise where foreign currency is acquired for personal use.[1] Under the so-called "separate transactions principle," both the courts and the IRS require that exchange gain or loss be separately accounted for, apart from any gain or loss attributable to an underlying transaction.[2]

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[1] See Rev. Rul. 74-7, 1974-1, C.B. 198 (the IRS ruled that a taxpayer who converts U.S. dollars to a foreign currency for personal use—while traveling abroad—realizes exchange gain or loss on reconversion of appreciated or depreciated foreign currency).

[2] Although the law on this point is fairly well settled, there is a contrary line of older cases that provides authority for determining overall gain or loss by aggregating exchange gain or loss and gain or loss from the underlying transaction. *Compare National-Standard Co.* v. *Commissioner*, 80 T.C. 551 (1983), *aff'd*, 749 F.2d 369 (6th Cir. 1984) (where the taxpayer and the IRS stipulated that the separate transactions principle applied) *with Bowers* v. *Kerbaugh-Empire Co.*, 271 U.S. 170 (1926) (where the U.S. Supreme Court determined that no net income was realized where the overall transaction generated a loss that exceeded an exchange gain on repayment of a foreign currency loan). There are two well recognized exceptions to the separate transactions principle: (1) a dealer in foreign exchange can use the lower of cost or value to determine foreign currency inventory, (Rev. Rul. 75-104, 1975-1 C.B. 18), and (2) a foreign branch of a U.S. taxpayer may translate unremitted foreign-currency denominated profits into dollars at the exchange rate in effect at the end of a taxable year, as described below.

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Debt denominated in a foreign currency

Treatment of debtors

In general.—A taxpayer may borrow foreign currency to use in a trade or business (e.g., to satisfy an account payable) or to make an investment in a foreign country. At maturity of a loan denominated in a foreign currency, typically, the taxpayer must obtain units of the foreign currency—in exchange for U.S. dollars—to repay the loan. If the foreign currency increases in value before the repayment date, the amount of U.S. dollars required to retire the debt exceeds the U.S.-dollar value of the foreign currency originally borrowed, and the taxpayer suffers an economic loss. Conversely, if the foreign currency depreciates in value, the taxpayer discharges the debt at a reduced cost (because fewer U.S. dollars are needed to obtain the number of units of foreign currency originally borrowed); here, the taxpayer realizes an economic gain.

Example (1).—Assume a U.S. taxpayer borrows 24 million Japanese yen when the rate of exchange is 240 yen per U.S. dollar. Thus, the U.S.-dollar value of the loan is $100,000.[3] At maturity of the loan, the borrower must repay 24 million yen, without regard to fluctuations in the yen:dollar exchange rate.

If the exchange rate on the date of repayment were 220 yen per dollar (i.e., if the U.S.-dollar value of the yen increased to approximately $.004545), there would be a loss of $9,091 because $109,091 would be needed to purchase 24 million yen.[4]

If the exchange rate on the date of repayment were 260 yen per dollar (i.e., if the U.S.-dollar value of the yen fell to approximately $.003846), there would be a gain of $7,692 because only $92,308 would be required to obtain 24 million yen.

Character of exchange gain or loss on repayment.—Characterization as capital gain or loss depends on whether the discharge of a foreign-currency denominated obligation is viewed as the disposition of a "capital asset"[5] in a sale or exchange.

There is a substantial body of case law under which the use of property to discharge an obligation is treated as a sale or exchange of the property.[6] Under this line of cases, realized gain or loss is measured by the difference between the adjusted basis of the property transferred and the principal amount of the obligation. In light of this authority, because foreign currency is treated as property, the IRS has taken the position that the transfer of foreign currency to pay a debt constitutes a sale or exchange. Thus, in the IRS's view, capital gain or loss results, unless the foreign currency

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[3] At the exchange rate of 240:1, the yen has a U.S.-dollar value of about $.004167. ($.004167 x 24 million = $100,000.)

[4] ($.004545 x 24 million = $109,091.)

[5] The term "capital asset" includes all classes of property not specifically excluded by Section 1221 of the Code. Foreign currency generally falls within the definition of a capital asset; however, under *Corn Products Refining Co.* v. *Commissioner*, 350 U.S. 46 (1955), property that satisfies the literal language of section 1221 of the Code is not considered a capital asset if the property is used by a taxpayer as an integral part of a trade or business.

[6] *See, e.g., Kenan* v. *Commissioner*, 114 F.2d 217 (2d Cir. 1940) (where property was transferred in satisfaction of a legatee's claim against an estate); *Rogers* v. *Commissioner*, 103 F.2d 790 (9th Cir. 1939), cert. denied, 308 U.S. 580 (1939) (where property was transferred in return for cancellation of a note representing part of the purchase price); Rev. Rul. 76-111, 1976-1 C.B. 214. *See also, United States* v. *Davis*, 370 U.S. 65 (1962) (where property was transferred to a spouse to discharge marital claims; this particular result was reversed by the Deficit Reduction Act of 1984).

was used by the borrower as an integral part of its ordinary trade or business under the Corn Products doctrine.[7]

The Sixth Circuit Court of Appeals, as well as the U.S. Tax Court (with seven dissents), rejected the IRS's view that repayment of a foreign currency loan constitutes a sale or exchange.[8] The Sixth Circuit relied on a 1939 case in which the U.S. Supreme Court held that the repayment of a debt is not considered a sale or exchange as to the creditor because the debtor does not receive property in the transaction.[9] Accordingly, because a sale or exchange is a prerequisite for capital gain or loss treatment, the Sixth Circuit held that an exchange loss on repayment of a foreign-currency denominated debt was an ordinary loss.

In an earlier case, the Sixth Circuit characterized exchange gain as income from the discharge of indebtedness.[10] Business taxpayers rely on this decision to defer the recognition of an exchange gain on repayment of a loan, by electing to reduce the basis of depreciable property by a corresponding amount (under sections 108 and 1017 of the Code), while immediately claiming exchange losses on similar transactions.

Finally, the borrowing and repayment of a foreign currency has been analogized to a "short sale," an analysis that supports capital gain or loss treatment unless the Corn Products doctrine applies.[11] In a short sale, the taxpayer sells borrowed property and later closes the short sale by returning identical property to the lender. Under section 1233(a) of the Code, gain or loss (computed by comparing the adjusted basis of the property used to close the short sale with the amount realized when the borrowed property was sold) is considered gain or loss from the sale or exchange of a capital asset if the property used to close the short sale is a capital asset in the hands of the taxpayer.

Source rules.—The source of an exchange gain or loss is important because of its impact on the calculation of the foreign tax credit limitation (as described more fully below, the amount of the credit is limited to the portion of U.S. tax liability that is attributable to foreign-source taxable income). Sections 861, 862, and 863 of the Code, and the accompanying regulations, provide rules for allocating income or gain to a domestic or a foreign source. Under the "title passage" rule, gain from the sale of personal property generally is treated as foreign source if the property is sold outside the United States; however, the re-sourcing rule of section 904(b)(3)(C) of the Code could apply to recharacterize a taxpayer's foreign source capital gain as domestic source gain for purposes of the foreign tax credit limitation.[12]

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[7] See Rev. Rul. 78-396, 1978-2 C.B. 114; Rev. Rul. 78-281, 1978-2 C.B. 204; G.C.M. 39294 (June 15, 1984).

[8] *National-Standard*, 749 F.2d. 369 (6th Cir. 1984), aff'g 80 T.C. 551 (1983).

[9] *Fairbanks* v. *United States*, 306 U.S. 436 (1939), *aff'g* 95 F.2d 794 (9th Cir. 1938) (the result in the case was reversed by statute).

[10] *Kentucky & Indiana Terminal Railroad Co.* v. *United States*, 330 F.2d 520 (6th Cir. 1969). *See also, Gillin* v. *United States*, 423 F.2d 309 (Ct. Cl. 1970).

[11] *See National-Standard*, 80 T.C. at 567-568 (Judge Tannenwald's dissent).

[12] Section 904(b)(3)(C) was designed to limit abuse of the "title passage" rule (i.e., the making of sales abroad solely to generate foreign source gains and thereby increase the foreign tax credit limitation), and applies unless (1) personal property is sold by an individual in a foreign country where the individual was resident, (2) in the case of any taxpayer, the property was sold

Continued

Losses from the disposition of capital assets or assets described in section 1231(b) of the Code (relating to property used in a trade or business) are apportioned between foreign and domestic income by reference to the source of the income to which the property ordinarily gives rise (Treas. reg. sec. 1.861-8(e)(7)). Otherwise, losses are generally allocated and apportioned between foreign and domestic gross income (e.g., on the basis of the location of the taxpayer's property).

Treatment of creditors

If a taxpayer makes a loan of foreign currency and is repaid with appreciated or depreciated currency, the taxpayer will realize exchange gain or loss on the repayment.[13] Under section 1271 of the Code, amounts received by the holder on retirement of a debt instrument are treated as received in a sale or exchange. The character of the gain or loss depends on whether the debt instrument constitutes a capital asset in the hands of the holder.

Accounts payable or receivable

A U.S. taxpayer may agree to make or receive payment in a foreign currency for the sale of goods or the performance of services, thereby creating a foreign currency denominated account payable or account receivable, respectively. Foreign exchange gain or loss will arise if the value of the foreign currency appreciates or depreciates before the account is settled. Under the case law, exchange gain or loss arising from accounts payable or receivable is recognized at the time of payment.[14]

Character.—There is no legal significance whether foreign currency is borrowed from a third-party or borrowed, in effect, by credit extended by a seller.[15] Consistent with the Corn Products doctrine, exchange gain or loss attributable to the settlement of a trade payable or receivable is generally characterized as ordinary income or loss.[16]

Source of exchange gain or loss on accounts payable or receivable.—Applicable rules generally source income from the sale of inventory under the title passage test. Similarly, income from the performance of services is sourced by reference to the place where

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in a country in which the taxpayer derived more than 50 percent of its gross income for the three-year period preceding the sale, (3) a foreign tax of ten percent or more was paid on the sale or exchange, or (4) a corporation sells shares in a second corporation in the country in which the second corporation is resident, and the second corporation derived more than 50 percent of its gross income from that country during the preceding three-year period.

[13] *See KVP Sutherland Paper Co.* v. *United States*, 344 F.2d 377 (Ct. Cl. 1965). In *KVP Sutherland*, the court found three recognition events in a loan transaction: (1) the exchange of foreign currency for a note, (2) the receipt of foreign currency on repayment, and (3) the conversion of the foreign currency received on repayment to U.S. dollars.

[14] *See Bennett's Travel Bureau, Inc.*, 29 T.C. 198 (1956) (where the taxpayer accrued a deduction for accounts payable in Norwegian kroner but, in a later year, settled the account at less than the U.S.-dollar amount it had deducted); *Foundation Co.*, 14 T.C. 1333 (1950) (where the taxpayer performed services in Peru and accrued Peruvian soles, and the currency's value at the time of payment was lower than when the income was accrued).

[15] *See American-Southeast Asia Co., Inc.*, 26 T.C. 198, 201 (1956) (where the U.S. Tax Court considered this point).

[16] *See Church's English Shoes, Ltd.*, 24 T.C. 56 (1955), *aff'd per curiam*, 229 F.2d 957 (2d Cir. 1956) (where the taxpayer imported goods on credit, the purchase of foreign currency to settle the account payable was viewed as part of the taxpayer's ordinary business, and, thus, an exchange gain was taxable as ordinary income). *See also*, I.R.C. sec. 1221(4) (an account receivable acquired for services rendered or sales of property in the ordinary course of business is excluded from the definition of a capital asset).

the services were performed. As noted above, losses are generally allocated and apportioned between domestic and foreign sources. In view of the separate transactions principle, however, it is unclear whether exchange gain or loss on settlement of an account relating to the sale of inventory or the performance of services would be sourced or allocated under the general rules discussed above.

Interest on foreign currency denominated debt

Rules of general application.—Normally, a debt instrument is issued at a price approximately equal to the amount that will be received by the lender at maturity, and the return to the lender is entirely in the form of periodic interest payments. In the case of a debt instrument that is issued at a discount, the issue price is less than the amount to be repaid to the lender, and the lender receives some or all of the return in the form of price appreciation. The original issue discount ("OID") is functionally equivalent to an increase in the stated rate of interest, i.e., OID compensates the lender for the use of the borrowed funds. If a debt instrument is issued at a premium, the issue price is more than the amount to be repaid to the lender.

In general, interest is includible in the lender's income (and deductible by the borrower) when paid or accrued. The issuer of an OID instrument is allowed deductions for, and the holder of the instrument is required to include in income, the daily portions of OID determined for each day of the taxable year the instrument is held (secs. 163(e) and 1272). If an instrument is issued at a premium, the premium is treated as income that must be prorated or amortized over the life of the instrument (Treas. reg. sec. 1.61-13(c)). The holder of an instrument issued at a premium can elect to deduct equal annual amounts over the life of the obligation (sec. 171).

Amortization of OID or bond premium.—The rules for amortizing OID parallel the manner in which interest would accrue through borrowing with interest-paying nondiscount bonds (under the constant yield method).[17]

OID is allocated over the term of a debt instrument through a series of adjustments to the issue price for each accrual period (generally, each six-month—or shorter—period determined by reference to the date six months before the maturity date). The adjustment to the issue price for each accrual period is determined by multiplying the issue price (as increased by prior adjustments) by the instrument's yield to maturity, and then subtracting the interest actually payable during the accrual period. The adjustment to the issue price for any accrual period is the amount of OID allocated to that accrual period. Although the economic arguments underlying the treatment of OID are equally applicable to premium, taxpayers are not required to use the constant yield method to amortize premium.

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[17] Essentially, the borrower is treated as paying the lender the annual interest accruing on the outstanding principal balance, which interest is deductible by the borrower and includible in the income of the lender, and the lender is deemed to lend the same amount back to the borrower. Thereafter, the borrower is deemed to pay interest on the unpaid interest as well as the principal balance. This concept of accruing interest on unpaid interest is commonly referred to as the economic accrual of interest or compounding.

Present law is unclear regarding the treatment of discount or premium on foreign-currency denominated obligations. For example, it is unclear whether OID is computed by reference to the U.S.-dollar value of a foreign currency at the time an obligation is issued, or is computed in terms of the foreign currency and translated into dollars at the average value in each period that OID accrues.

Measurement of interest income and deductions in deferred payment transactions.—Prior to 1984, the OID provisions did not apply to an obligation issued for nonpublicly traded property where the obligation itself was not publicly traded. The principal reason for this exception was the perceived difficulty in determining the value of nonpublicly traded property, and hence the issue price of (and the amount of OID implicit in) the obligation. Congress addressed this valuation problem by providing objective rules that prescribe an issue price for an obligation issued for nonpublicly traded property (sec. 1274).

Section 1274 performs two roles: (1) testing the adequacy of stated interest, and, where stated interest is inadequate, recharacterizing a portion of the principal amount as interest, and (2) prescribing the issue price. If the prescribed issue price is less than the debt instrument's stated redemption price at maturity, the differential is treated as OID. These calculations are made by reference to the "applicable Federal rate" (generally, the average yield on marketable obligations of the U.S. government with a comparable maturity, referred to as the "AFR").

Under a literal reading of section 1274, an obligation issued for foreign currency is subject to the rules for deferred payment transactions. Proposed regulations provide that, in the case of a debt instrument the repayment of which is denominated in a foreign currency, the AFR is the analogous foreign currency rate of interest (Treas. reg. sec. 1.1274-6(c).

Below market loans.—Under section 7872, certain below market loans (including any extension of credit) are treated as economically equivalent to loans bearing interest at the AFR, coupled with a payment by the lender to the borrower sufficient to fund the payment of interest by the borrower. Proposed regulations provide that, for purposes of applying these rules to a foreign currency denominated loan, a market rate of interest appropriate to the currency is used rather than the AFR, although the proposed regulations leave open the issue of how the imputed transfer from the borrower to the lender is to be treated (Prop. Treas. reg. sec. 1.7872-11(f)).

Treatment of market discount.—A market discount bond is an obligation that is acquired for a price that is less than the principal amount of the bond (or less than the amount of the issue price plus accrued OID, in the case of an OID bond). Market discount generally arises when the value of a debt obligation declines after issuance, typically, because of an increase in prevailing interest rates or decline in the credit worthiness of the borrower. Gain on disposition of a market discount bond is recognized as interest income, to the extent of accrued market discount (generally computed under a linear formula, although a taxpayer can elect to use the constant yield method described above). Accrued market discount is not

treated as interest for purposes of withholding at source, information reporting requirements, or such other purposes as the Secretary may specify in regulations.

Thirty-percent withholding.—In certain cases, U.S.-source interest income received by a foreign person is subject to a flat 30-percent tax on the gross amount paid, subject to reduction in rate or exemption by tax treaties to which the United States is a party (secs. 871(a) and 881).[18] The tax is generally collected by means of withholding by the person making the payment to the foreign recipient (secs. 1441 and 1442). The 30-percent tax is inapplicable if the interest is effectively connected with a U.S. trade or business of the foreign recipient; instead, the income is reported on a U.S. income tax return and taxed at the rates that apply to U.S. persons. The 30-percent tax is inapplicable to interest paid by a U.S. borrower on certain portfolio debt and other investments.

Allocation of U.S. taxpayer's interest expense.—A U.S. taxpayer's deduction for interest expense is generally apportioned between domestic and foreign source gross income in proportion to the borrower's domestic and foreign assets, or, within limits, domestic and foreign source gross income (Treas. reg. sec. 1.861-8(e)(2)).

Hedging transactions

A U.S. taxpayer can "hedge" against changes in the dollar value of foreign-currency denominated assets and liabilities.

Example (2).—In example (1), above, where a U.S. taxpayer borrows 24 million yen when the exchange rate is 240:1, the borrower could hedge against a potential exchange loss (i.e., protect itself against possible appreciation in the value of the yen to be repaid) by entering into a "forward contract" (defined below) to purchase at the maturity of the loan, 24 million yen at a predetermined exchange rate.

Assuming the forward and spot rates are the same (because there is no interest rate differential between the yen and dollar on the day the forward contract is entered into), if the exchange rate rose to 220:1, the borrower could obtain yen under the forward contract at the lower 240:1 rate, and save $9,091 (the additional $9,091 that would have been required to purchase 24 million yen at the current rate).

If the exchange rate fell to 260:1, the borrower would still be obligated to purchase yen at the rate specified in the forward contract, although the obligation could be terminated by making a cash payment.

The U.S. tax consequences of a transaction that is undertaken to hedge foreign exchange exposure turn, in large part, on (1) the nature of the financial product used to effect the hedge, and (2) whether the hedging transaction relates to the taxpayer's own business operations or the business operations of an affiliate. Further, different tax rates could apply to the positions included in a hedging transaction, with the result that a transaction that produces no economic gain or loss could result in an after-tax profit or loss.

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[18] The 30-percent withholding tax also applies to other fixed or determinable annual or periodical income from U.S. sources.

Description of certain financial products

A variety of financial products are available for use in reducing the impact of exchange rate fluctuations on foreign-currency denominated assets or liabilities.

Forward contracts.—Trading in foreign currency is conducted in an informal interbank market through negotiated forward contracts. A forward contract calls for delivery or purchase of a specified amount of foreign currency at a future date, with the exchange rate fixed when the contract is made. Forward exchange rates (i.e., premiums or discounts) are determined by reference to interest rate differentials in the interbank deposit market. The currency with the lower interest rate trades at a higher forward price than the spot rate (i.e., at a "forward premium"); the difference between the spot rate and the forward price of the currency with a higher interest rate is referred to as a "forward discount."

Example (3) (pricing a forward contract).—Assume that the three-month deposit rate for Deutsche marks is 8 percent compounded quarterly (for a three-month yield of 2 percent), and the three-month deposit rate for U.S. dollars is 10 percent compounded quarterly (for a three-month yield of 2-1/2 percent). The spot rate for Deutsche marks is 2.1 (i.e., DM2.1 = $1). If the forward exchange market is perfectly efficient, the three-month forward exchange rate for Deutsche marks should be 2.0898, determined according to the following formula:

$$\frac{\text{DM2.1}\ ^{1}\times 1.02\ ^{2}}{\$1\times 1.025\ ^{2}} = 2.0898$$

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[1] The spot rate.

[2] One plus the interest rate.

Thus, a taxpayer who requires Deutsche marks in three months time (e.g., to settle an account payable) can either purchase Deutsche marks at the current exchange rate (or "spot rate") and deposit them, or enter into a forward purchase contract, and obtain approximately the same results.

Regulated futures contract.—A futures contract is a standardized forward contract to sell or purchase a specified amount of foreign currency during a designated month in the future. A regulated futures contract ("RFC") is defined for purposes of section 1256 of the Code (discussed below) as a contract that is traded on or subject to the rules of a domestic board of trade designated as a contract market by the Commodity Futures Trading commission (or any board of trade or exchange approved by the Treasury Department), and that is "marked to market" (defined below in the discussion of section 1256 of the Code) under a cash settlement system of the type used by U.S. futures exchanges to determine the amount that must be deposited due to losses, or the amount that may be withdrawn in the case of gains (as the result of price changes with respect to the contract). The utility of futures contracts as hedging

tools is limited, primarily because contracts in excess of 12 months are difficult to obtain.

A variety of foreign currency futures (covering, for example, Deutsche marks, British pounds, and Japanese yen) are traded on the New York Futures Exchange and the International Monetary Market of the Chicago Mercantile Exchange, among others.

Foreign currency options.—A foreign currency option is a contract under which the "writer" grants the "holder" the right to purchase or sell the underlying currency for a specified price during the option period. The consideration (or premium) for option rights is paid at acquisition, and the holder has no further obligations under the option unless or until the option is exercised. Foreign currency options are written by banks, as well as traded publicly on exchanges such as the Chicago Mercantile Exchange and the Philadelphia Stock Exchange.

Example (4).—On the facts of example (2), above, instead of entering into a forward contract, the borrower could acquire an option to purchase 24 million yen at 240 yen per dollar. In such a case, although the borrower would incur the cost of the option premium, if the yen:dollar exchange rate were to fall to 260:1, the borrower would not be contractually bound to purchase the yen at the higher cost. Rather, the option could be allowed to expire unexercised, and the 24 million yen could be acquired at the lower current rate.

Parallel or back-to-back loans.—In a back-to-back loan, a taxpayer who requires a foreign currency loan first borrows U.S. dollars, and then lends those dollars to a foreign person; contemporaneously, the foreign person lends foreign currency of equal value to the U.S. taxpayer. The terms of the loan agreements are substantially identical, and both loans mature on the same date. In a parallel loan, the borrowers and lenders are separate entities (*e.g.*, a U.S. parent corporation lends dollars to the U.S. subsidiary of a French corporation, and the French corporation lends French francs to the French subsidiary of the U.S. parent corporation).

Parallel and back-to-back loans may present legal issues involving the secured transactions and insolvency laws of several jurisdictions, and a party to such a transaction could be required to repay a loan even if the other party is prevented from repaying the corresponding loan (*e.g.*, because of a bankruptcy proceeding).

Currency swaps.—Currency swaps were developed as an alternative to parallel loans. A currency swap generally involves an exchange of U.S. dollars for foreign currency at the spot rate, coupled with an agreement to reverse the transaction on a future date at the original exchange rate. A swap can be structured so that there is no actual exchange of currencies; the parties to the swap can simply obtain currency in the spot market and agree to make payments to each other (i.e., to swap the interest and principal payments). A currency swap avoids the legal issues presented by parallel or back-to-back loans because each party's obligation to deliver currency is conditioned on performance by the other party.

There is a question under present law as to whether swap payments made by a U.S. taxpayer constitute U.S.-source "fixed or determinable annual or periodical income," and, thus, are subject to 30-percent withholding. A related issue is whether an exemption

from withholding is available under an income tax treaty to which the United States is a party on the ground that swap payments constitute: (1) "industrial and commercial profits" not attributable to a permanent establishment, or (2) in the case of the U.K. and several other treaties, "other income" that is taxable only by the country of the recipient's domicile.

Interest rate swaps.—In an interest rate swap, the parties agree to make periodic payments to each other, the amounts of which are determined by reference to a prescribed principal amount. Typically, an interest rate swap involves a borrower with access to fixed-rate debt and another borrower with access to floating-rate debt. In a cross-currency interest rate swap, each party pays the other an amount determined by reference to the recipient's interest rate.

Although the swap payments are measured by interest payments, they are not viewed as interest because they are not paid as compensation for the use or forbearance of money.

Application of provisions relating to tax straddles

Specific statutory rules prevent the use of "straddles" to defer income or to convert ordinary income (or short-term capital gain) to long-term capital gain. In general, a tax straddle is defined as offsetting "positions" with respect to personal property (sec. 1092(c)). The term position is generally defined as an interest (including a futures or forward contract) in personal property of a type that is actively traded. Positions are offsetting if there is a substantial diminution in the risk of loss from holding one position by reason of holding one or more other positions in personal property.

By their terms, the tax straddle rules apply to most transactions undertaken to hedge foreign exchange exposure, unless the transaction generates only ordinary income or loss (and otherwise satisfies the requirements of the statutory hedging exemption described below).

Loss deferral rule.—If a taxpayer realizes a loss on the disposition of one or more positions in a straddle, the amount of the loss that can be deducted is limited to the excess of the loss over any unrecognized gain in offsetting positions (sec. 1092(a)). In addition, taxpayers are required to capitalize otherwise deductible expenditures for property that is part of a straddle, except to the extent of income received with respect to the property (sec. 263(g)).

Taxpayers question whether a currency swap constitutes a position in a straddle if the risk of loss on a foreign currency loan or borrowing is diminished thereby. If so, the capitalization requirement would apply, and the deduction of swap payments would be limited to the payments received from the other party to the swap unless the hedging exemption (described below) applies.

Mark-to-market rules.—An RFC or a nonequity option that is traded on (or subject to the rules of) a qualified board of trade or exchange (including a foreign currency option) and that is held by a taxpayer at year-end is treated as if it were sold for its fair market value on the last business day of the year (sec. 1256(a)(1)). Positions that are subject to mark-to-market treatment are referred to as section 1256 contracts. Any gain or loss on a section 1256 contract is generally treated as 40-percent short-term capital

gain or loss and 60-percent long-term capital gain or loss. For purposes of these rules, a foreign currency forward contract is treated as a section 1256 contract, if the contract is traded in the interbank market, and is entered into at an arm's length price determined by reference to the price in the interbank market (sec. 1256(g)).

Mixed straddles.—In general, the loss deferral rule applies to a straddle composed of both section 1256 contracts and positions that are not marked-to-market. The section 1256 contracts in a mixed straddle are excluded from the mark-to-market rules if the taxpayer designates the positions as a mixed straddle by the close of the day on which the first section 1256 contract is acquired (or such earlier time as the Secretary may require).

Under present law, some taxpayers question whether an obligor's interest in a foreign currency denominated loan constitutes a position in personal property for purposes of the tax straddle rules.

Example (5).—Assume a foreign-currency denominated loan is treated as a position and is offset by a forward purchase contract that is subject to the mark-to-market rule (which would occur if no mixed straddle election were made). Assume further that the taxpayer uses the loan proceeds to make an investment. If the forward contract is marked to market at a loss (because the currency depreciated), the loss would be deferred until the offsetting gain attributable to the loan is recognized. If the taxpayer realizes capital gain on the repayment of the loan, the gain would be offset by 60/40 loss attributable to the forward contract. Assuming the capital gain is short-term (because the currency was acquired shortly before it is used to repay the loan), the 60/40 loss could result in the conversion of unrelated long-term capital gain to short-term capital gain. This would occur because 40 percent of the loss on the forward contract would offset 40 percent of the short-term capital gain, and 60 percent would be applied first to the taxpayer's long-term capital gain from the unrelated transaction, leaving 60 percent of the short-term gain on the loan repayment. In this case, there is an adverse tax result even though the transaction is a wash from an economic perspective.

A taxpayer could avoid these results by making a mixed straddle election and foregoing mark-to-market and 60/40 gain treatment. A taxpayer may fail to make a timely election, however, because of uncertainty in determining whether positions in foreign currency are part of a straddle, or because offsetting positions are established inadvertently.

Termination of rights under a forward contract.—Gain or loss from the cancellation, lapse, expiration, or other termination of a right or obligation with respect to personal property is treated as capital gain or loss, except in the case of the retirement of a debt instrument (sec. 1234A). Property subject to this rule is any personal property of a type that is actively traded and that is (or would be on acquisition) a capital asset in the hands of the taxpayer. Thus, the settlement of a foreign-currency forward contract would generate capital gain or loss unless the Corn Products doctrine applies, regardless of the manner in which the contract is terminated.

Hedging exception.—Certain hedging transactions are exempt from the loss deferral, mark-to-market, and capitalization rules (secs. 1092(e) and 1256(e)). For purposes of this exception, a hedging

transaction is generally defined as a transaction that is executed in the normal course of a trade or business primarily to reduce certain risks, and results only in ordinary income or loss. Under a special rule for banks (as defined in section 581), a bank's transactions need not satisfy the primary purpose requirements applicable to other taxpayers. This hedging exception applies to a transaction that reduces the risk of (1) price change or foreign currency exchange rate fluctuations with respect to property held or to be held by the taxpayer, or (2) interest rate or price changes, or foreign currency exchange rate fluctuations with respect to borrowings or obligations of the taxpayer. For purposes of these rules, a hedging transaction must be clearly identified before the close of the day the transaction is entered into.

Taxpayers claim uncertainty in determining whether the hedging exemption applies because of the requirements that the transaction be entered into in the normal course of a trade or business and result only in ordinary income or loss, which requirements implicate the Corn Products doctrine. Consider the case of a U.S. corporation that satisfies a need for U.S. dollars by borrowing foreign currency for immediate conversion to U.S. dollars, and then hedges the foreign currency loan (by a currency swap or a forward exchange contract, for example). Assume that the loan proceeds are used for general corporate purposes in the United States. A U.S. corporation might engage in this type of transaction to take advantage of anomalies in foreign capital markets (e.g., the willingness of lenders to accept a lower rate of return on loans of certain currencies). Some taxpayers take the position that the hedging exemption applies to this situation. Apparently, corporate borrowers rely on the case law that supports ordinary income or loss treatment on repayment of a foreign currency loan; however, it is not clear that such transactions are entered into in the normal course of a trade or business.

Related provisions: short sale rules of section 1233.—Present law provides rules that are designed to eliminate specific devices in which short sales could be used to transform short-term capital gain into long-term capital gain, or long-term capital loss into short-term capital loss (sec. 1233(b) and (d)). The rules are stated to apply to stock, securities, and commodity futures, but not to hedging transactions in commodity futures (sec. 1233(e)). Under these rules, if a taxpayer holds property for less than the period required for long-term capital gain treatment, and sells short substantially identical property, any gain on closing the short sale is considered short-term capital gain and the holding period of the substantially identical property is generally considered to begin on the date of the closing of the short sale (sec. 1233(b)).

There are several cases that support the position that section 1233(b) is inapplicable to the sale of a foreign currency forward contract.[19] The IRS, however, has taken a contrary view.[20]

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[19] *American Home Products Co.* v. *United States*, 601 F.2d 540 (Ct. Cl. 1979); *Carborundum Co.*, 74 T.C. 730 (1980).

[20] Technical Advice Memorandum 8016004 (December 18, 1979). Although a technical advice memorandum is not binding as precedent on the IRS or the courts, a technical advice memorandum is helpful in interpreting the law in the absence of clear authority.

Hedges relating to foreign subsidiaries

Under the case law, the Corn Products doctrine is applied to hedging transactions only if the hedge relates to the taxpayer's "own" day-to-day business operations. Thus, a hedging transaction with respect to the separate operations of a foreign subsidiary corporation is not treated as falling within the doctrine.[21]

Foreign currency translation

Under present law, a taxpayer operating abroad is permitted to maintain the books and records of operation in a foreign currency. The method of translating the results of the taxpayer's foreign operation depends on whether the activity is conducted through a branch or through a subsidiary corporation. Additional requirements are imposed if the taxpayer operates through a subsidiary that is a "controlled foreign corporation" (generally, a foreign corporation more than 50 percent of the voting stock of which is owned by U.S. persons who own 10 percent or more of such stock, referred to as a "CFC").

Present law does not prescribe criteria for use in determining when it is appropriate to record the results of a foreign operation in a foreign currency. Further, for the most part, the method used to translate foreign currency results into U.S. dollars is left to the taxpayer's discretion. The recognized translation methods can produce substantially different U.S. tax consequences.

Branches

A foreign branch that maintains a separate set of books in a foreign currency can use either a "profit and loss" or a "net worth" method to determine U.S. taxable income attributable to the branch operation.[22]

Under the profit and loss method, the net profit computed in the foreign currency is translated into dollars at the exchange rate in effect at the end of the taxable year. If the branch made remittances during the year, these amounts are translated into U.S.-dollars at the exchange rate in effect on the date remitted, and only the balance of the profit, if any, is translated at the year-end exchange rate.

Under the net worth method, U.S. taxable income is defined generally as the difference between the branch's net worth at the end of the prior taxable year and at the end of the current taxable year. Under this method, the branch's balance sheet is translated into U.S. dollars. In general, the values of current assets and liabilities are translated at the year-end exchange rate, and fixed (long-term) assets are translated at the exchange rate in effect on the

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[21] *International Flavors & Fragrances*, 62 T.C. 232 (1974), *rev'd and rem'd*, 524 F.2d 357 (2d Cir. 1975), *on remand*, 36 T.C.M. 260 (1977) (taxpayer sold British pounds short to hedge net asset position of U.K. subsidiary); *The Hoover Co.*, 72 T.C. 206 (1979) (taxpayer entered into forward contracts to offset potential decline in value of stock in a foreign subsidiary), *nonacq.*, 1980-1 C.B. 2 (the nonacquiescence relates to the court's holding that Hoover's sale of a forward purchase contract for foreign currency shortly before the time set for performance—but after the currency was devalued—resulted in long-term capital gain; the IRS's concern was based on the fact that short-term capital gain would have resulted if the taxpayer had accepted delivery under the contract and then exchanged the foreign currency).

[22] *See* Rev. Rul. 75-107, 1975-1 C.B. 32 (relating to the profit and loss method); *and* Rev. Rul. 75-106, 1975-1 C.B. 31, *and* Rev. Rul. 75-134, 1975-1 C.B. 33 (relating to the net worth method).

date the asset was acquired (the "historical rate"). The translation of an item at its historical rate defers recognition of exchange gain or loss. Remittances are translated at the exchange rate in effect on the date of remittance, and are then added to the U.S.-dollar amount computed by comparing year-end balance sheets.

The choice of a method for translating the income of a branch is viewed as a method of accounting, and, thus, cannot be changed without the consent of the Secretary.[23] The profit and loss and net worth methods produce different results, primarily because changes in the values of current assets and liabilities are taken into account annually under the net worth method, but not under the profit and loss method.

When a foreign branch remits currency in excess of the current year's profit, the basis of the excess amount must be determined in order to calculate exchange gain or loss. Present law does not provide explicit rules for calculating exchange gain or loss on remittances.

Distributions from foreign corporations

A domestic corporation is subject to tax on its worldwide income. Foreign corporations generally are taxed by the United States only on income that is effectively connected with a U.S. trade or business and on certain passive income from U.S. sources. As a result, under the general rules, income derived by a U.S. person through a foreign corporation operating abroad is not subject to tax unless and until the income is distributed to U.S. shareholders. An exception to the general rule of deferral is provided by the subpart F provisions of the Code (secs. 951-964), under which income from certain tax-haven type activities is taxed to certain U.S. shareholders of CFCs on a current basis.

Controlled foreign corporations

The "subpart F" income of a CFC is taxed to "U.S. shareholders" as a constructive dividend, to the extent of post-1962 earnings and profits (secs. 951 and 952(c)). The term "U.S. shareholder" is generally defined as a U.S. person who owns 10 percent or more of a CFC's voting stock (sec. 951(b)). "Subpart F" income generally includes income from (1) related-party sales and services transactions through tax-haven base companies, (2) the insurance of U.S. risks, (3) shipping operations (unless the income is reinvested), (4) oil related activities, and (5) passive investments (sec. 952). A loan with a term of more than one year from a CFC to a related U.S. person generally is treated as an investment in U.S. property (sec. 956), with the result that the amount of the loan is treated as a constructive distribution to U.S. shareholders under the subpart F provisions (sec. 951(a)(1)(B)). A constructive distribution under subpart F includes a pro rata portion of the CFC's exchange gain or loss.

Applicable Treasury regulations provide rules for translating a CFC's earnings and profits and subpart F income (Treas. reg. secs. 1.964-1(a)-(e)). Under the subpart F method of translation, earnings and profits are calculated by (1) computing the sum of the CFC's

[23] *See American Pad & Textile Co.*, 16 T.C. 1304 (1951), *acq.*, 1951-2 C.B. 1.

profit or loss, and (2) adding to that amount the exchange gain or loss determined by comparing the CFC's balance sheet (after the elimination of the dollar value of the translated profit or loss, distributions, and other items) with its balance sheet as of the end of the previous year (referred to as the "full subpart F method"). The earnings and profits so computed are translated at an "appropriate rate of exchange" (generally, a monthly average of the exchange rates in effect for the taxable year).[24]

Gain from sale or exchange of stock in certain foreign corporations

Gain recognized on the sale or exchange of stock in a foreign corporation by a U.S. shareholder (as defined above) is recharacterized as dividend income, to the extent of the foreign's corporation's post-1962 earnings and profits attributable to the period the stock sold was held by the shareholder while the corporation was a CFC (sec. 1248). For purposes of computing the section 1248 constructive dividend, a foreign corporation's earnings and profits are translated into U.S. dollars under the full subpart F method (described above) (Treas. reg. sec. 1.1248-2(d)(2)).

Computation of foreign tax credit

In general, a credit against U.S. tax liability is allowed for foreign income taxes paid or accrued with respect to foreign-source income (sec. 901). The purpose of the foreign tax credit generally is stated to be to mitigate the effects of double taxation of income that is subject to tax by both the United States and a foreign government. The allowable foreign tax credit for a taxable year is limited to U.S. tax liability multiplied by a fraction the numerator of which is foreign-source taxable income and the denominator of which is worldwide taxable income (sec. 904(a)).

For purposes of section 901 of the Code, foreign taxes are deemed paid with respect to dividends received by a U.S. corporation that owns at least 10 percent of the voting stock of the distributing foreign corporation (sec. 902). Generally, foreign taxes are also deemed paid with respect to Subpart F constructive dividends (sec. 960). Thus, these dividends carry with them a proportionate amount of the foreign taxes paid by the foreign corporation.

Direct credit

In the case of foreign taxes paid on income derived directly through branch operations, taxpayers generally are required to translate the foreign taxes into U.S. dollars at the exchange rate in effect on the date such taxes were paid or accrued.[25] If the amount of foreign taxes accrued differs from the amount paid, or if a foreign tax is refunded (in whole or in part), a taxpayer must notify the IRS, and redetermine the allowable credit for the taxable year (sec. 905(c)). The rule requiring an adjustment upon the payment of accrued foreign taxes is applied by comparing the U.S.-dollar value of the amount accrued to the U.S.-dollar value of the amount actu-

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[24] *See* Treas. reg. sec. 1.964-1(d)(2). If the value of the relevant currency fluctuates substantially during the year, the appropriate rate of exchange might be a weighted monthly average, depending on whether that rate more closely approximates the results of translating individual transactions at the exchange rates in effect when the transactions occurred.

[25] Rev. Rul. 73-491, 1973-2 C.B. 268.

ally paid.[26] Thus, with respect to foreign taxes that are accrued but not paid, subsequent exchange rate fluctuations are taken into account under section 905(c) of the Code.

If a foreign tax is refunded, under the case law, taxpayers are permitted to redetermine the allowable credit by translating the foreign refund into U.S. dollars at the rate of exchange in effect on the date of refund.[27]

Example (6) (refund of foreign tax).—Assume that a taxpayer pays a 10,000 Swiss franc tax when one franc is equal to $.50 (so the U.S.-dollar cost would be $5,000). In a later year, the entire 10,000 franc tax is refunded when one franc is equal to $.40 (so the U.S.-dollar value of the refund is only $4,000). Under the relevant authorities, a $1,000 tax would be eligible for credit even though the entire foreign tax was refunded.

Indirect credits

To calculate the amount of foreign taxes deemed paid under section 902 of the Code, the amount of foreign taxes paid with respect to the earnings out of which the distribution is made is multiplied by a fraction, the numerator of which is the amount of the dividend and the denominator of which is the amount of the accumulated profits out of which the dividend was paid (referred to as the "section 902 fraction") (sec. 902(a)).

To calculate the amount of foreign taxes deemed paid under section 960 of the Code, foreign taxes paid are multiplied by a fraction, the numerator of which is the Subpart F income and the denominator of which is the CFC's earnings and profits (referred to as the "section 960 fraction").

Actual distributions.—In the case of an actual distribution, the regulations promulgated under section 902 of the Code provide that accumulated profits denominated in a foreign currency are translated into U.S. dollars at the exchange rate in effect on the date the dividend is distributed (Treas. Reg. sec. 1.902-1(g)(1)). At the taxpayer's election, accumulated profits are computed under the profit and loss method prescribed by the regulations promulgated under section 964 (referred to as the "limited subpart F method," because there is no requirement that the balance sheet be translated) (Treas. reg. sec. 1.902-1(g)(2)). In addition, under the authority of the *Bon Ami Co.* case, the amount of the dividend and the foreign taxes deemed paid are also translated at the exchange rate in effect on the date of distribution.[28] By its terms, section 905(c) applies to taxes that are deemed paid; however, the use of the current exchange rate to translate foreign taxes deemed paid effectively negates the requirement that a foreign tax be redetermined if there is a difference between the amount accrued and the amount paid. These rules also apply to constructive dividends under section 1248 (Treas. reg. sec. 1.1248-1(d)(1)).

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[26] *First Nat'l City Bank* v. *United States*, 557 F.2d 1379 (Ct. Cl. 1977); *Comprehensive Designers International Ltd.*, 66 T.C. 348 (1976); Rev. Rul. 73-506, 1973-2 C.B. 268.

[27] *American Telephone & Telegraph* v. *United States*, 430 F. Supp. 172 (S.D.N.Y. 1977), *aff'd* 567 F.2d 554 (2d Cir. 1978) Rev. Rul. 58-237, 1958-1 C.B. 534.

[28] 39 B.T.A. 825 (1939) (a case decided under the predecessor to section 902 of the Code). *But see American Metal Co.*, 221 F.2d 134, 141 (2d Cir. 1955) (when the foreign corporation keeps its books in U.S. dollars, foreign taxes are translated as of payment date).

In the case of a constructive dividend under section 1248, under a literal reading of the applicable regulations, the amount of the dividend in the section 902 fraction is translated under the full subpart F method at an average exchange rate, while accumulated profits and foreign taxes are translated at the exchange rate in effect on the date of the deemed dividend under section 1248.[29]

Example (7).—Assume that a French subsidiary corporation has accumulated profits of 400 French francs before French tax and that a French tax of 100 was paid. Assume further that the profits were earned, and the tax paid, when the French franc was worth $.20. Thus, a French tax with a value of $20 was paid with respect to $80 of income, resulting in an effective tax rate of 25 percent. If the earnings are distributed after the franc's value has fallen to $.10, the parent corporation would be deemed to have paid $10 of French tax ($30/$30 x $10).[30] If the franc's value rose to $.25, the parent corporation would be deemed to have paid $25 of French tax ($75/$75 x $25). In either case, the amount of French tax eligible for credit would equal 25 percent of the U.S.-dollar value of the accumulated profits before tax; however, the U.S.-dollar cost of the French tax paid would be understated or overstated, depending on whether the franc's value depreciated or appreciated.

Subpart F constructive dividends.—The full subpart F method is mandated for purposes of computing the deemed-paid credit under section 960 of the Code. Thus, because the balance sheet is translated, exchange gain or loss on current assets is taken into account in computing earnings and profits for purposes of the section 960 fraction.

Where the U.S. dollar value of a CFC's balance sheet items declines, the application of the full subpart F method can produce a more favorable result for the taxpayer. This is because taking exchange losses into account reduces earnings and profits (the denominator of the section 960 fraction), and thereby increases the allowable deemed-paid foreign tax credit. Under present law, a taxpayer whose CFC has a net exchange loss, but no subpart F income, can effectively elect to use the full subpart F method to increase the deemed-paid credit. This result can be accomplished by repatriating earnings in the form of subpart F income, instead of having the CFC make an actual dividend distribution. Subpart F income can be triggered (and earnings repatriated), for example, by having a CFC make a loan that extends for more than one year to a U.S. shareholder.

Related financial accounting standards

There was no uniform system of accounting for foreign currency transactions prescribed by the accounting profession prior to the issuance of Statement of Financial Accounting Standards No. 8

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[29] *But see* G.C.M. 37133, (May 24, 1977) (concluding that accumulated profits should also be determined under the full subpart F method). Although a G.C.M. is not binding as a precedent on the IRS or the courts, a G.C.M. is helpful in interpreting the law in the absence of clear authority. *See also*, D. Ravenscroft, Taxation and Foreign Currency 627 (1973) (for an argument that the numerator in the section 902 fraction could be determined under the limited subpart F method, since the full subpart F method of determining earnings and profits is only a limitation on the amount that can be treated as a section 1248 dividend).

[30] The after-tax accumulated profits are included in the denominator (300 x $.10 = $30).

("FAS 8") by the Financial Accounting Standards Board. FAS 8, which was issued in 1975 effective for fiscal years beginning on or after January 1, 1976, generally required the inclusion of exchange gain or loss in net income for financial reporting purposes.

In 1981, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 52 ("FASB 52"), relating to foreign currency translation, for application to foreign currency transactions and financial statements of foreign entities (including branches and subsidiaries). FASB 52 introduced the "functional currency" approach, under which the currency of the economic environment in which a foreign entity operates generally is used as the unit of measure for exchange gains and losses. Under FASB 52, in most cases, exchange gain or loss is treated as an adjustment to shareholders equity, and not as an adjustment to net income. In defining a "reporting enterprise," FASB 52 distinguishes a "self-contained" operation from an operation that is an integral extension of a U.S. operation; in the latter case, the indicated functional currency is the U.S. dollar.

Reasons for Change

Present law is unclear regarding the character, the timing of recognition, and the source of gain or loss due to fluctuations in the exchange rate of foreign currency. Further, present law does not prescribe rules for determining when the results of a foreign operation can be recorded in a foreign currency, and taxpayers are permitted to use a method of translating foreign-currency results into U.S. dollars that is inconsistent with general Federal income tax principles. The result of the state of present law is uncertainty of tax treatment for many legitimate business transactions, as well as opportunities for tax-motivated transactions. The committee determined that a comprehensive set of rules should be provided for the U.S. tax treatment of transactions involving foreign currency.

Functional currency

The financial accounting concept of functional currency provides a reasonable basis for determining the amount and the timing of recognition of exchange gain or loss. The bill reflects the principle that income or loss should be measured in the currency of a taxpayer's primary economic environment. Under this approach, the U.S. dollar will be the functional currency of most U.S. persons. The committee recognized, however, that there are circumstances in which it is appropriate to measure the results of a U.S. person's foreign operation in a foreign currency so that a taxpayer is not required to recognize exchange gain or loss on currency that is not repatriated but is used to pay ordinary and necessary expenses.

Foreign currency transactions

The lack of a coherent set of rules for the treatment of foreign currency transactions results in uncertainty. The courts have addressed several issues by applying general Federal income tax rules that produce anomalous results when applied to exchange gain or loss (e.g., the treatment of exchange gain on repayment of a loan as income from discharge of indebtedness that is eligible for deferral).

Other issues are treated by old cases that are inconsistent with current case law, but that have not been expressly overruled (e.g., whether exchange gain or loss is integrated with gain or loss from an underlying transaction). Further, the IRS and the courts have taken contrary positions with respect to certain issues (e.g., whether a debtor's exchange gain or loss on repayment of a loan is capital or ordinary in nature).

Multi-currency contracts

Commentators have suggested that U.S. tax consequences can be manipulated by arranging to repay a foreign-currency denominated loan in U.S. dollars equivalent in value at repayment to the foreign currency borrowed.[31] Foreign lenders and U.S. borrowers have utilized a form of debt security under which the lender may dictate the currency in which repayment is to be made. By way of example, it is argued that characterization of an exchange loss on a loan repayment as a capital loss would be avoided if the loan is repaid in U.S dollars, since repayment with U.S. dollars would not involve a sale or exchange. This view ignores the economic reality that the resulting gain or loss would still be attributable to the value of the foreign currency borrowed.[32] More recently, taxpayers have issued so-called "dual currency bonds," where the principal is payable in U.S. dollars but interest is payable in a foreign currency. The bill makes clear that the economic substance of a foreign-currency denominated transaction is determinative of the U.S. tax consequences.

Character of exchange gain or loss

Effect of exchange gain or loss on interest denominated in a foreign currency

Commentators have observed that a loan denominated in a foreign currency may reflect a "true" U.S.-dollar interest rate plus an anticipated annual exchange gain or loss.[33] For example, a U.S. taxpayer who borrows a currency that is viewed as strong in relation to the dollar would pay less interest than if the taxpayer had borrowed dollars (because the lender expects to be repaid with appreciated currency). Conversely, if the taxpayer obtains a loan denominated in the currency of a country experiencing high rates of inflation, so that the currency is viewed as weak in relation to the dollar, the taxpayer would pay more annual interest than if dollars had been borrowed. In such cases, at least to the extent the parties' expectations prove to be correct, or the parties hedge their posi-

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[31] Committee on Foreign Activities of U.S. Taxpayers, Section of Taxation, American Bar Association, Report on the U.S. Treasury Department Discussion Draft on Taxing Foreign Exchange Gains and Losses, 36 Tax L. Rev. 425, 441 (1981). For a contrary view, *see Newman*, "Tax Consequences of Foreign Currency Transactions: A Look at Current Law and an Analysis of the Treasury Department Discussion Draft," 36 Tax Lawyer 223, 236 (1983).

[32] *See American Air Filter Co.*, 81 T.C. 709 (1983) (where a loan agreement provided that a liability payable in foreign currency could be converted to one payable in another currency, the conversion to a U.S.-dollar liability was treated as a realization event); G.C.M. 39294 (June 15, 1984) (where the IRS noted that repayment in U.S. dollars instead of foreign currency does not alter the tax consequences).

[33] *See, e.g.*, New York State Bar Association's Ad Hoc Committee on Original Issue Discount and Coupon Stripping, "Preliminary Report on Issues to be Addressed in Regulations and Corrective Legislation," Tax Notes, March 5, 1984, pp. 993-1034.

tions, it is arguable that nominal interest is understated or overstated, respectively.

The relationship between the dollar price of foreign currency in the forward market and the market interest rate for such currency relative to the dollar supports the view that exchange gain or loss should be treated as interest income or expense. On the other hand, the "interest equivalency" approach fails to take into account other factors (*e.g.*, a borrower's creditworthiness) that affect the stated rate of interest on a foreign currency debt. Even commentators who favor the interest equivalency approach for certain purposes (*e.g.*, characterization) question the result for other Federal income tax purposes (*e.g.*, rules that disallow interest allocable to investments such as tax-exempt bonds). Further, although expectations regarding a currency's future value are material in setting the rate of return on a financial asset or liability, exchange gain or loss could be more or less than expected.

Treatment of exchange gain or loss as ordinary income or loss under the bill

The committee did not adopt the interest equivalency approach in its entirety, but concluded that characterizing exchange gain or loss as ordinary income or loss for most purposes is a pragmatic solution to an issue about which tax scholars and practitioners hold disparate views. The committee bill authorizes the Secretary to treat exchange gain or loss as interest income or expense in appropriate circumstances (*e.g.*, in the case of hedging transactions where a taxpayer's expectations about future exchange rates are locked in).

The committee considered whether unanticipated exchange gain or loss on a financial asset or liability should be characterized as capital gain or loss. This approach was not followed because it is difficult to distinguish anticipated exchange gain or loss from unanticipated exchange gain or loss. Anticipated gain or loss could be measured with reference to the premium or discount element in a forward contract had one been obtained; however, forward contracts are not available in all currencies and do not trade at all maturities. Even where anticipated gain or loss is determinable (*e.g.*, were a taxpayer enters into a forward contract), the bill treats all such gain or loss as ordinary in nature to reduce discontinuities. The narrowing of the rate differential between ordinary income and capital gain for corporations and the elimination of the differential for individuals under the bill reduces the importance of capital gain characterization. A limited exception to this treatment is provided for certain contracts that capital assets in the hands of the taxpayer and are properly identified as speculative investments.

Timing of recognition

Advocates of the interest equivalency approach suggest that a taxpayer's interest income or expense should be adjusted (upwards or downwards) on a current basis, to reflect the "true" borrowing cost or interest income. The current accrual of exchange gain or loss on a borrowing is said to be necessary to properly allocate the

additional "interest" to each year the borrowing is outstanding (to match income and expense).

The committee was not persuaded that exchange gain or loss should be currently accrued in most cases. Because a right to receive (or an obligation to pay) foreign currency is not a right (or obligation) to receive (or pay) a fixed number of dollars, it would be problematical to require income inclusions (or permit deductions) due to exchange gain or loss that could be lost through subsequent exchange rate fluctuations.

The Secretary is authorized to prescribe rules for the current accrual of exchange gain or loss in certain hedging transactions. Further, although the committee determined that the Secretary has adequate regulatory authority under the OID and below-market-loan rules to require the proper matching of income and expense on most foreign currency denominated loans (including any extension of credit), the committee's bill grants additional regulatory authority to recharacterize interest and principal payments with respect to obligations denominated in hyperinflationary currencies.

Sourcing rules

Exchange gain on a financial asset or liability could be viewed as either foreign source (if ordinary in nature) or domestic source (if treated as capital gain and section 904(b)(3)(C) applies). The source of a loss on repayment is even less clear. Commentators have suggested the following possibilities for allocating exchange losses: (1) exchange loss could be apportioned between domestic and foreign source income in the proportions that these amounts bear to each other in the aggregate, (2) an analogue to the "title passage" rule could apply to allocate losses to foreign source income, or (3) the loss could be allocated by reference to the source of the gain or loss from the underlying transaction.

The committee determined that the overriding consideration should be to provide certainty regarding the source of exchange gain or loss. The bill accomplishes this result by providing definitive rules that are consistent with the treatment of foreign currency as personal property and the amendments to the sourcing rules in section 611 of the bill. In general, the bill requires the sourcing of exchange gains and the allocation of exchange losses by reference to the residence of the taxpayer or qualified business unit of the taxpayer on whose books the underlying transaction is properly reflected. For most U.S. taxpayers, this rule will result in the treatment of exchange gain or loss as domestic source or allocable thereto. This result will tend to neutralize the effect of exchange gain or loss on the calculation of foreign tax credits (unlike present law, under which wide swings in exchange rates can result in unpredictable reductions in net foreign source income). Under regulations, exchange gain or loss on certain hedging transactions will be treated in a manner that is consistent with income or expense on the underlying transaction.

Foreign currency translation

The bill utilizes the functional currency approach to distinguish between foreign business operations that are eligible to determine income or loss in a foreign currency (before translation into U.S.

dollars) and other foreign operations (the income or loss from which must be measured in dollars, transaction-by-transaction). Under the bill, results recorded in a foreign currency must be translated into U.S. dollars under a profit-and-loss method. The bill generally retains the present law rules relating to translation of foreign tax credits, with limited clarifications.

Adoption of profit-and-loss method

The committee is concerned about the implicit election enjoyed by CFCs to recognize net exchange losses, and thereby distort the calculation of the deemed-paid foreign tax credit. The Committee was informed of the argument that the electivity achieved by deciding when to trigger subpart F income could be addressed by requiring an irrevocable election to use a profit and loss method or a net worth method. In considering this option, the Committee noted that exchange rate fluctuations with respect to certain currencies are predictable with considerable accuracy (e.g., the continuing depreciation of the Brazilian cruzeiro relative to the U.S. dollar). A taxpayer almost always would elect the net worth method for operations in a country with a weak currency (to accelerate losses) and the profit and loss method for operations in a country with a strong currency (to defer gain). Further, the committee concluded that the results achieved under a net worth method are inconsistent with general Federal income tax principles that do not recognize gains and losses until realized.

A profit and loss method can be viewed as being more consistent with the functional currency concept than a net worth method. Under a profit and loss method, the functional currency is used as the measure of income or loss, so that earnings determined for U.S. tax purposes bear a close relation to taxable income computed by the foreign jurisdiction. Further, a profit and loss method minimizes the accounting procedures that otherwise would be required to make item-by-item translations under a net worth method. Finally, in the case of a branch, the net worth method as applied under present law fails to characterize accurately items of income or loss that are subject to special U.S. tax rules. For example, although there are limitations on the deductibility of long-term capital losses, such a loss incurred by a branch would be given tax effect because it would be reflected as an adjustment to the balance sheet. (The bill authorizes regulations to prescribe an approximate separate transactions method that does not accelerate the recognition of exchange gain or loss, for application in certain circumstances.)

Appropriate exchange rates

The committee concluded that the use of a year-end exchange rate distorts income and does not reflect the fact that gain or loss is realized continuously during a taxable year. Accordingly, in most cases, the bill requires the use of weighted average exchange rates (similar to the present law requirements applicable to CFCs).

Remittances from branches and certain distributions from subsidiaries

In the case of a branch, because the profit and loss method would not translate balance sheet gains and losses, some mechanism for recognizing gains and losses inherent in functional currency or other property remitted to the home office must be provided. A similar issue arises in the case of controlled foreign corporations. Under another provision of the bill, for purposes of the indirect tax credit, the treatment of distributions from controlled foreign corporations as dividends is determined by treating distributions as made from a 10-year pool of all of the distributing corporation's earnings and profits. Under the bill, the pooling approach also is used to compute exchange gain or loss on distributions of previously taxed income from CFCs. One of the reasons for the adoption of the pooling approach is to reverse certain present-law consequences that result in the disparate treatment of branch operations and operations conducted through a subsidiary. Similarly, the committee adopted a pooling approach for purposes of determining exchange gain or loss on branch remittances.

Foreign tax credits

The bill generally requires the translation of foreign taxes at the same exchange rate that is used to translate the related income inclusion. Consistent with this general rule, the bill preserves the Bon Ami rule applicable for purposes of the indirect credit.

The committee considered the perceived defects of the Bon Ami approach (*e.g.*, the calculation of an indirect credit without regard to the economic cost of the foreign tax); however, the committee was not persuaded that a more theoretical approach would justify the resulting administrative complexity. Further, the Bon Ami approach preserves the historic ratio between foreign taxes and accumulated profits, so that the U.S. dollar value of the foreign tax eligible for credit is the same percentage of the U.S.-dollar value of the dividend as the effective foreign-currency denominated tax was of the related earnings.

Explanation of Provisions

1. Overview

The bill sets forth a comprehensive set of rules for the treatment of foreign currency denominated transactions, in new subpart J. Under the bill, the tax treatment of a foreign currency denominated transaction turns on the identity of the taxpayer's functional currency. Exchange gain or loss is recognized on a transaction-by-transaction basis only in the case of transactions involving certain financial assets or liabilities (referred to as "section 988 transactions") that are denominated in a nonfunctional currency. In the case of section 988 transactions, exchange gain or loss generally is treated as ordinary income or loss. To the extent provided in regulations, exchange gain or loss on certain hedging contracts is characterized and sourced in a manner that is consistent with the related exposure, and a portion of the unrealized exchange gain or loss on section 988 transactions is accrued currently.

A uniform set of criteria is provided for determining the currency in which the results of a foreign operation should be recorded. Business entities using a functional currency other than the U.S. dollar generally are required to use a profit and loss translation method. Exchange gain or loss on a remittance from a branch is treated as ordinary income or loss from domestic sources. A consistent set of rules applies to the translation of foreign taxes and adjustments thereto.

2. Functional currency

In general

New section 985(a) generally requires all Federal income tax determinations to be made in a taxpayer's functional currency. The functional currency approach presupposes a long-term commitment to a specific economic environment.

The general rule under the bill requires that taxpayers use the U.S. dollar as the functional currency. Thus, except as otherwise provided, taxpayers must measure income or loss from dealings in foreign currency in U.S. dollars, on a transaction-by-transaction basis. In certain circumstances, (described below), a taxpayer is required to use a foreign currency as the functional currency of a "qualified business unit" (generally, a self-contained foreign operation). Under such circumstances, income or loss derived from a qualified business unit is determined in a foreign currency (before translation into U.S. dollars). In general, the use of a foreign currency as the functional currency of a qualified business unit will result in the deferral of exchange gain or loss from transactions conducted in that currency.

Business entities

The special rule for qualified business units addresses the treatment of cases in which a single taxpayer has multiple operations in different economic environments. In such a case, a taxpayer may be eligible to account for the results of a foreign operation by measuring income or loss in the currency of the host country (or, in appropriate circumstances, another foreign country). The application of the rule for qualified business units is conditioned on the determination that the foreign operation represents a sufficient commitment to the economic environment of the host country.

In general, the rule for qualified business units will apply where the foreign operation constitutes a trade or business, the activities of which primarily are conducted in the local currency. The bill contemplates that the U.S. dollar will be used as the functional currency of a foreign operation that is an integral extension of a U.S. operation (*e.g.*, a foreign corporation whose sole function is to act as a financing vehicle for affiliated U.S. corporations, or a foreign corporation used to hold portfolio stock investments or similar passive assets that could readily be carried on the parent corporation's books), or a foreign operation with a limited duration (e.g., an offshore construction project undertaken by a U.S. taxpayer).

Qualified business units

The functional currency of a qualified business unit is the currency of the economic environment in which a significant part of its business activities are conducted, and in which such unit keeps its books and records (new section 985(b)(1)(B)). A single taxpayer can have more than one qualified business unit.

Definition of qualified business unit.—The term qualified business unit is defined as any separate and clearly identified unit of a taxpayer's trade or business, if such unit maintains separate books and records (new sec. 989(a)). A qualified business unit must include every operation that forms a part of the process of earning income. In general, the statutory definition is satisfied on the basis of vertical, functional, or geographical divisions of a single trade or business, if the business unit is capable of producing income independently.[34]

Identification of functional currency.—To identify the functional currency of a qualified business unit, the taxpayer must establish that books and records are maintained in the currency of the economic environment in which a significant part of the unit's activities are conducted. The identification of a functional currency requires a factual determination. In making the required determination, the factors taken into account shall include but not be limited to: (1) the currency in which books and records are maintained, (2) the principal currency in which revenues and expenses are generated, (3) the principal currency in which the business unit borrows or lends, and (4) the functional currency of related business units and the extent to which the business unit's operations are integrated with those of related business units (if a business unit is an integral component of a larger operation, the economic environment of the larger operation governs the choice of a functional currency). These factors generally correspond to the current criteria that is used to identify a functional currency for financial accounting purposes.[35]

The functional currency of a qualified business unit is deemed to be the U.S. dollar if the unit's activities are conducted primarily in dollars (new sec. 985(b)(2)). It is intended that taxpayers use consistent criteria for identifying the functional currency of qualified business units engaged in similar activities in different countries. If the facts and circumstances do not indicate a particular currency (e.g., where an entity conducts significant business in more than one currency), a taxpayer has discretion in choosing a functional currency. The choice of a functional currency, including an election to use the U.S. dollar (described below), is treated as a method of accounting that can be changed only with the consent of the Secretary (and pursuant to such conditions as the Secretary may pre-

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[34] An operation that meets this standard is not automatically treated as a separate trade or business for other purposes of the Internal Revenue Code. For example, geographical separation would not provide a basis for treating a business unit as a trade or business under section 446(d), which section permits a single taxpayer to use different accounting methods for separate trades or businesses. Thus, apart from the adoption of a foreign currency as the functional currency of a qualified business unit—which is itself a method of accounting—a taxpayer may be required to use consistent accounting methods for its foreign operations (*e.g.*, cash versus accrual accounting).

[35] *See* Statement of Financial Accounting Standards No. 52, "Foreign Currency Translation," issued by the Financial Accounting Standards Board (December 7, 1981).

scribe). The Secretary shall address in regulations the appropriate treatment of taxpayers whose functional currency changes.

The examples below illustrate the identification of a functional currency on the basis of the criteria described above.

Example (1)—A U.S. parent corporation, P, has a wholly owned U.S. subsidiary, S, whose head office is in the United States, although its primary activity is extracting natural gas and oil through a branch in a foreign country. Sales of natural gas and oil are billed in both U.S. dollars and local currency, and significant liabilities and expenses (e.g., loan principal and interest) are denominated in both dollars and local currency. The foreign country requires the branch to keep its books and records in the local currency. In filing federally mandated financial statements P and S elect to use the dollar, not the local currency.

Absent other factors pointing to the predominance of the dollar (such as a high volume of intercompany activities with dollar-based affiliates or a U.S. sales market), the facts do not clearly require the specification of a particular currency. In such a case, the taxpayer would have discretion in choosing between the dollar and the local currency.

Example (2)—A bank incorporated and with its head office in the United States has a branch in a foreign country. Although the foreign country requires the branch to keep books in the local currency, the branch customarily fixes the terms of its loans to local customers by reference to a contemporary London Inter-Bank Offered Rate (LIBOR) on dollar deposits (e.g., the interest rate on outstanding loan principal equals LIBOR plus two percent and outstanding loan principal is adjusted to reflect changes in the dollar value of the local currency). Local lending is, in turn, typically funded with dollar-denominated funds borrowed from the head office, other branches and subsidiaries of the same bank, and independent lenders. In turn, the branch lends dollars. The bank elects to use the dollar, not the local currency, for Federally mandated financial reporting purposes.

In this instance, although the branch maintains its books and records of operation in foreign currency, the branch's activity is conducted primarily in the U.S. dollar. Under the bill, the branch would be required to use the dollar as its functional currency.

Example (3)—A U.S. taxpayer incorporates a wholly owned subsidiary in Switzerland. All books and records are maintained in Swiss francs, and the Swiss franc is used for financial reporting purposes. The Swiss company is primarily a base company selling the exports of its U.S. parent corporation, and virtually all of its income is foreign base company sales income within the meaning of section 954. Most of its transactions are denominated in U.S. dollars or, less frequently, in foreign currencies other than the Swiss franc.

Under the bill, the U.S. dollar is the functional currency of the Swiss company even though its books and records are maintained in Swiss francs and the Swiss franc is used for financial reporting purposes. This result obtains because the Swiss company's activities are primarily conducted in U.S. dollars.

Election to use U.S. dollar

The bill provides that a qualified business unit can elect to use the U.S. dollar as its functional currency but only if the unit maintains its books and records in the U.S. dollar (*i.e.*, uses the separate transaction method) or uses a translation method that approximates dollar-based accounting. The election is effective for the taxable year for which made and all subsequent taxable years, unless revoked with the consent of the Secretary. For a U.S. person, the election is to be made on the return for the first taxable year for which a qualified business unit exists, by making a statement that the qualified business unit elects the U.S. dollar as its functional currency for U.S. tax purposes. For a foreign person, the election is to be made in the U.S. owner's return for the first taxable year in which the U.S. owner acquires at least a 50-percent ownership interest in the foreign person by making a statement that the foreign person's qualified business unit elects the U.S. dollar as its functional currency for U.S. tax purposes.

The Secretary is granted limited authority to prescribe rules under which the U.S. dollar can be elected as the functional currency even if books and records are not kept in dollars, if a qualified business unit uses a method of translation that approximates the results of determining exchange gain or loss on a transaction-by-transaction basis. The bill contemplates that regulations may implement this authority by requiring, for example, the comparison of year-end balance sheets using historical exchange rates for *all* balance sheet items. The committee included regulatory authority for this limited exception to the dollar-based books requirement to address the concerns of taxpayers operating in hyperinflationary economies. In such a case, dollar based accounting might not accurately reflect the income or loss of a taxpayer with substantial fixed plant and equipment (because the local currency depreciation charge will become insignificant in relation to operating income). For these taxpayers, an election to use the U.S. dollar as the functional currency will not be conditioned on conforming books and records.

3. Foreign currency transactions

In general

New section 988 prescribes rules for the treatment of exchange gain or loss from transactions denominated in a currency other than a taxpayer's functional currency. For taxpayers using the U.S. dollar as a functional currency, the bill generally retains the present law principles under which the disposition of foreign currency results in the recognition of gain or loss, and exchange gain or loss is separately accounted for (apart from any gain or loss attributable to an underlying transaction). Similarly, as under present law, the recognition of exchange gain or loss generally requires a closed and completed transaction (*e.g.*, the actual payment of a liability). The bill modifies present law regarding the character, source, and—in limited circumstances as provided by regulations—the timing of recognition of exchange gain or loss. Under the bill, foreign-currency denominated items are to be translated into U.S. dollars using the exchange rate that most properly re-

flects income; generally, the appropriate exchange rate will be the free market rate.

Section 988 transactions

New section 988(c) defines the term "section 988 transaction" to mean certain transactions in which the amount required to be paid or entitled to be received is denominated in a nonfunctional currency, or is determined by reference to the value of one or more nonfunctional currencies. Section 988 transactions are: (1) the acquisition of (or becoming the obligor under) a debt instrument, (2) accruing (or otherwise taking into account) any item of expense or gross income or receipt that is to be paid or received on a later date, (3) entering into or acquiring an interest in any forward contract, option, or similar investment position (such as a currency swap), if such position is not marked to market under section 1256, and (4) the disposition of nonfunctional currency. The positions included in a mixed straddle that is identified under section 1256(d) are not treated as section 988 transactions. For purposes of the rule for dispositions of nonfunctional currency, the term nonfunctional currency includes not only coin and currency, but also nonfunctional currency denominated demand or time deposits and similar instruments issued by a bank or other financial institution.

A section 988 transaction need not require or even permit repayment with a nonfunctional-currency, as long as the amount paid or received is determined by reference to the value of a nonfunctional currency. (Thus, the status of multi-currency contracts is clarified.) Examples of section 988 transactions are trade receivables or payables, preferred stock (to the extent provided by regulations), and debt instruments denominated in one or more nonfunctional currencies. For purposes of these rules, the term debt instrument means a bond, debenture, note, certificate, or other evidence of indebtedness.

The Secretary is authorized to prescribe regulatory rules that exclude certain transactions from the definition of a section 988 transaction. The bill contemplates that regulations will except any class of items the taking into account of which is not necessary to carry out the purposes of the rules for foreign currency gain or loss derived from section 988 transactions. Examples of items that are within the scope of the Secretary's regulatory authority are trade receivables and payables that have a maturity of 120 days or less, and any other receivable or payable with a maturity of six months or less that would be eligible for exclusion under section 1274 (relating to the determination of issue price of debt issued for nonpublicly traded property).

Treatment of foreign currency gain or loss from section 988 transactions as ordinary income or loss

In general, foreign currency gain or loss attributable to a transaction described in new section 988 is computed separately and treated as ordinary income or loss. Except as otherwise provided by regulations, capital gain or loss treatment is accorded to forward contracts, futures contracts, and options that constitute capital assets in the hands of the taxpayer and are not marked-to-market under section 1256 and that meet certain identification require-

ments. In circumstances to be identified in Treasury regulations (*e.g.*, certain hedging transactions, described below), foreign currency gain or loss will be treated as interest income or expense.

Foreign currency gain or loss

Foreign currency gain or loss is defined as gain or loss realized by reason of a change in the exchange rate between the date an asset or liability is taken into account for tax purposes (referred to as the "booking date") and the date it is paid or otherwise disposed of.

Definition of "booking date".—For transactions involving the acquisition of or becoming the obligor under a debt instrument, the booking date is the date of acquisition or on which the taxpayer becomes the obligor. For transactions involving items of expense or gross income, the booking date is the date on which the item is accrued or otherwise taken into account for Federal income tax purposes. For transactions involving forward contracts or similar investment positions, the booking date is the date on which the position is entered into or acquired.

Definition of payment date.—Generally, foreign currency gain or loss is realized on the date on which payment is made or received with respect to a section 988 transaction. For transactions involving forward contracts or similar investment positions, the bill makes clear that the payment date includes the date on which a taxpayer's rights are terminated with respect to the position (*e.g.*, by entering into an offsetting position).

Calculation of income from discharge of indebtedness.—The bill reverses the result in the *Kentucky & Indiana Terminal Railroad* case.[36] The bill contemplates that gain realized on repayment of a borrowing will be attributed first to foreign currency gain (by calculating the difference between the U.S. dollar value of the face amount when issued and when discharged), and only the balance will be treated as income from discharge of indebtedness (sec. 323 of the bill limits the ability to defer income from discharge of indebtedness to insolvent taxpayers).

Calculation of OID.—Although new section 985(a) generally requires a U.S. person to make Federal income tax determinations in terms of the U.S. dollar, the bill contemplates that—pursuant to the Secretary's authority to provide exceptions to this rule—the Treasury Department will issue regulations providing for the determination of OID on foreign currency obligations. Pending issuance of regulations, however, the Committee intends that OID for any accrual period will be determined in terms of units of foreign currency, and translated into U.S. dollars based on the average exchange rate in effect during the accrual period. The U.S. dollar amount of the OID deducted for any accrual period will be treated as the dollar amount added to the borrowing on account of the OID (to determine the adjusted issue price), for purposes of determining the extent of exchange gains or losses realized when the borrowing is repaid. Similar rules are to be prescribed for the calculation of

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[36] 330 F. 2d 520 (6th Cir. 1969)(exhange gain characterized as income from discharge of indebtedness).

bond premium (sec. 1803 of the bill requires taxpayers to use the constant yield method applicable to OID to amortize premium).

Example (4).—On December 31, 1986, the taxpayer issues for 85.82 Deutch marks (DM) a bond which provides for semiannual coupons of 1 DM and a final payment at maturity, on December 31, 1988, of DM100.00. The exchange rate on the date of issuance is $0.25/DM, so the amount of the borrowing initially is $21.45. The yield to maturity of the obligation, in terms of DM, is 5 percent, semiannually.

The accrual period is 6 months, commencing with the date of issuance. At the end of the first accrual period, on June 30, 1987, the first 1 DM coupon is paid. Stated interest payments are translated at the exchange rate in effect on the payment date. If the DM appreciates to $0.35 at the end of the first accrual period, the dollar amount of stated interest is $0.35 (1 DM times $0.35/DM). Accrued OID is DM3.29 (5 percent of DM85.82, less stated interest of 1 DM). This amount is translated into dollars using the average exchange rate during the accrual period. If the average value of the DM during the first accrual period is $0.30, then the dollar amount of OID accrued on June 30, 1987 is $0.99 (DM3.29 times $0.30/DM). The taxpayer deducts the dollar amount of accrued OID (in addition to interest paid translated at the payment date) and increases its dollar basis in the bond by the same amount (from $21.45 to $22.44).

As a result of the appreciation of the DM, the taxpayer has an accrued currency loss of $8.75, the difference between the dollar basis of the bond, $22.44 and the DM basis translated at the current exchange rate, $31.19 (DM89.11 times $0.35/DM). This accrued currency loss is not recognized until the taxpayer discharges its indebtedness. The currency loss is treated as ordinary income, and is allocated by reference to the issuer's residence.

Date Accrual Period Ends	Deutch Marks (DM)			End of Period Exch. Rate ($/DM)	Avg. Exch. Rate ($/DM)	Dollars ($)			
	Basis	Cash	Accrued OID			Basis	Cash	Accrued OID	Accrued Currency Gain
12/31/86	85.82			.25		21.45			
6/30/87	89.11	1.00	3.29	.35	.30	22.44	.35	.99	−8.75
12/31/87	92.56	1.00	3.45	.40	.37	23.72	.40	1.28	−13.30
6/30/88	96.19	1.00	3.63	.40	.40	25.17	.40	1.45	−13.30
12/31/88	100.00	1.00	3.81	.40	.40	26.70	.40	1.53	−13.30
12/31/88	0	100.00		.40	.40	0	40.00		−13.30
TOTAL		104.00	14.18				41.55	5.25	

Special rule for certain investment products

New section 988 does not change the treatment of bank forward contracts or regulated futures contracts that are marked to market under section 1256 or the treatment of mixed straddles that are identified under section 1256(d). The bill provides a special rule for certain financial instruments that are not marked-to-market (*e.g.*, because they are traded on a foreign board or exchange) but are held for speculation: these currency contracts are accorded capital gain or loss treatment if they constitute capital assets and the taxpayer properly identifies them. Under the bill, identification must be made before the close of the day the transaction is entered into (or such earlier time as the Secretary may prescribe by regulations).

Special rule for certain hedging transactions

The bill authorizes the issuance of regulations that address the treatment of section 988 transactions that are part of a hedge. The committee included this regulatory authority to provide certainty of tax treatment for foreign currency hedging transactions that are fast becoming commonplace (such as fully hedged foreign currency borrowings) and to insure that such a transaction is taxed in accordance with its economic substance. A hedging transaction includes certain transactions entered into primarily to reduce the risk of (1) foreign currency exchange rate fluctuations with respect to property held or to be held by the taxpayer, or (2) foreign currency fluctuations with respect to borrowings or obligations of the taxpayer. The bill provides that a hedging transaction is to be identified by the taxpayer or the Secretary.

To the extent provided in regulations, if any section 988 transaction is part of a hedging transaction all positions in the hedging transaction are integrated and treated as a single transaction, or otherwise treated consistently (*e.g.*, for purposes of characterizing the nature of income or the sourcing rules). The committee intends that these regulations address two different categories of hedging transactions.

The first category is a narrow class of fully hedged transactions that are in substance part of an integrated economic package through which the taxpayer (by simultaneously combining a bundle of financial rights and obligations) has assured itself of a cash flow that will not vary with movements in exchange rates. With respect to this category, the committee intends that such rights and obligations be integrated and treated as a single transaction with respect to that taxpayer. For example, in the case of a fully hedged foreign currency borrowing, a taxpayer with the dollar as its functional currency will borrow foreign currency and hedge its exposure by entering into a series of forward purchase contracts or a single swap agreement. The forward contracts or swap agreement will assure the taxpayer of a stream of foreign currency flows to make interest and principal payments with respect to the foreign currency borrowing. The taxpayer, although it has borrowed foreign currency, is not at risk with respect to currency fluctuations because it has locked in the dollar cost of its future foreign currency requirements. The committee intends that

regulations treat the entire package as a dollar borrowing with dollar interest payments with respect to the borrower.

In the case of a foreign currency borrowing hedged with a series of forward purchase contracts, the rules of section 1271, *et seq.* and 163(e) shall apply in determining the appropriate interest deduction. The committee intends that similar rules apply to synthetic dollar securities (e.g., a transaction in which a taxpayer with the dollar as its functional currency purchases a foreign currency denominated debt obligation and sells forward all interest and principal payments to assure itself a stream of fixed dollar flows). The committee intends that the regulations pertaining to integrated hedging transactions be restricted to transactions that are, in substance, equivalent to a transaction denominated in the taxpayer's functional currency.

The second category of hedging transactions involves transactions that are not entered into as an integrated financial package but are designed to limit a taxpayer's exposure in a particular currency (e.g., the acquisition of a foreign currency denominated liability to offset exposure with regard to a foreign currency denominated asset). These regulations need not provide for complete integration (e.g., the form of a foreign currency borrowing may be respected and the interest deduction determined by reference to the spot rate on the date of payment). Where appropriate, these regulations should provide for consistent treatment with respect to character, source, and timing.

The committee intends that both sets of regulations relating to hedging transactions provide rules to prevent taxpayers from selectively identifying only those transactions where the hedging rules are favorable to the taxpayer. The committee is aware that rules applicable to partially hedged transactions may be necessary to achieve a hedging rule that is not susceptible to abuse. The committee also intends that the regulations require a taxpayer to clearly identify a hedging transaction before the close of the day the transaction is entered into, in order to claim increased deductions attributable to the hedge. The Secretary may identify the transaction as a hedge at a later date. Further, (as discussed below), the committee's bill clarifies the interaction of these rules and the tax straddle provisions, with a view towards providing an incentive for taxpayers to properly identify section 988 transactions that are part of a tax straddle.

In addition, the regulations will need to take account of the various mechanisms for hedging currency exposure. For purposes of the special regulatory rules, a hedging position may include any contract (1) to sell or exchange nonfunctional currency at a future date under terms fixed in the contract, (2) to purchase nonfunctional currency with functional currency at a future date under terms fixed in the contract, (3) to exchange functional currency for a nonfunctional currency at a future date under terms fixed in the contract (which would include parallel loans and currency swaps), or (4) to receive or pay a nonfunctional currency (e.g., interest rate swaps denominated in a nonfunctional currency).

The committee particularly is concerned about hedging transactions where a taxpayer borrows in a weak currency and eliminates virtually all risk of currency loss by establishing offsetting curren-

cy positions. If such a hedging transaction is not treated as an integrated transaction, the taxpayer may be able to defer tax on income (and, under present law, to convert ordinary income to capital gains).

Example (5).—Assume that a taxpayer borrows 1000 units of a weak foreign currency ("F") for 2 years at 30 percent—the market interest rate in this currency. Interest payments are F300 in each of the next 2 years, plus a principal payment of F1000 in 2 years (see table below). The high interest rate charged by lenders of this currency, compared to dollar interest rates, reflects the anticipated devaluation of the foreign currency relative to the dollar.

The spot market rate for the foreign currency is F2 per dollar; therefore, the proceeds from the F1000 loan are $500 (F1000 divided by F2/$). Suppose the foreign currency can be purchased 1 year ahead in the forward market at F2.364 per dollar, and 2 years ahead at F2.793 per dollar. Under these facts, the taxpayer can cover its exchange rate exposure on future interest and principal payments by purchasing 1 year ahead F300 for $126.92 (F300 divided by F2.364/$), and 2 years ahead F1300 for $465.38 (F1300 divided by F2.793/$). If the taxpayer fully hedges, then the foreign currency borrowing effectively is converted into a dollar borrowing of $500 with a repayment schedule (interest and principal) of $126.92 next year and $465.38 in 2 years, resulting in a 10-percent yield to maturity in dollar terms. Under the special rules for integrating certain hedging transactions, a fully hedged foreign currency borrowing would be treated as the equivalent of a dollar borrowing.

One consequence of treating the hedging transaction described above as a dollar loan is that the deductibility of interest with respect to the loan is governed by the principles of the OID rules (sec. 1271 *et seq.*). Thus, if the hedging rule were applied, the loan would be treated as a dollar-equivalent loan with a 10-percent yield to maturity, rather than a 30-percent yield, as stated in the contract. Under the hedging rule, only $50.00 (10 percent of the $500 loan balance) of the $126.92 paid in the first year (to cover the F300 of foreign currency liability due in that year) would be characterized as interest expense, and the balance ($76.92) would be characterized as principal (see table below). Thus, in the first year, the effect of integrating the hedging transaction is to reduce the allowable interest deduction from $126.92 to $50.00.

Year	Foreign Currency Loan			Forward Market		Dollar-Equivalent Loan		
	Balance	Interest	Principal	Forward rate	Cost of Cover	Balance	Interest	Principal
	(F)	(F)	(F)	(F)	($)	($)	($)	($)
0	1000	0	0	2.000	0	500.00	0	0
1	1000	300	0	2.364	126.92	423.08	50.00	76.92
2	0	300	1000	2.793	465.38	0	42.30	423.08
Sum	NA	600	1000	NA	592.30	NA	92.30	500.00

Over the two-year period, the application of the rules for hedging transactions would not change the net amount of deductions ($92.30) arising from the foreign currency loan; instead, the hedging rule would require that interest be characterized and accrued according to OID principles. In the above example, the effect of the hedging rule is to prevent a one-year deferral of tax on $76.92 of income.

A similar rule would apply in the case of a fully-hedged borrowing in a strong currency (i.e., a currency with an interest rate lower than the dollar interest rate).

Sourcing rules

In general, foreign currency gain is sourced, and foreign currency losses are allocated, by reference to the residence of the taxpayer or qualified business unit on whose books the underlying financial asset or liability is properly reflected. For purposes of these rules, an individual's residence is defined as the country in which the "tax home" (as defined in sec, 911(d)(3) is located. In the case of any U.S. person (as defined in sec. 7701(a)(30)) other than an individual, the residence is the United States. In the case of a foreign corporation, partnership, trust, or estate, the residence is treated as a foreign country. Where appropriate, foreign currency gain or loss that is treated under the section 988 hedging rules to be prescribed by regulations (discussed above) is to be sourced or allocated in a manner that is consistent with that of the hedged item.

Exception for qualified business units

The residence of a taxpayer's qualified business unit (including the qualified business unit of an individual) is the country in which the unit's principal place of business is located.

Special rule for certain related party loans

The bill provides a special rule for purposes of determining the source or allocation of exchange gain or loss from certain related party loans. This rule was included because of a concern that the general rule that looks to residence could be manipulated to artifically increase foreign source income for purposes of computing allowable foreign tax credits. Under the special rule, affected loans are marked-to-market on an annual basis, and interest income earned on the loan during the taxable year is treated as domestic source income to the extent of any loss on the loan.

The special rule applies to a loan by a U.S. person or a related person (*e.g.*, a foreign subsidiary) to a 10-percent owned foreign corporation, which loan is (1) denominated in a currency other than the dollar, and (2) bears interest at a rate at least 10 percentage points higher than the AFR for mid-term Federal obligations at the time the loan is made. A 10-percent owned foreign corporation means any foreign corporation in which the taxpayer owns directly or indirectly at least 10 percent of the voting stock. This rule applies only for purposes of subpart J and section 904.

Application to transactions of a personal nature

Section 988 applies to transactions entered into by an individual only to the extent that expenses attributable to such transactions

would be deductible under section 162 (as a trade or business expense) or section 212 (as an expense of producing income, other than expenses incurred in connection with the determination, collection or refund of taxes). Thus, for example, section 988 is inapplicable to exchange gain or loss recognized by a U.S. individual resident abroad upon repayment of a foreign currency denominated mortgage on the individual's principal residence. The principles of current law would continue to apply to such transaction.

Tax straddle provisions

The bill coordinates the interaction of the rules for foreign currency gain or loss derived from section 988 transactions and the tax straddle provisions. Neither the loss deferral rule of section 1092 nor the mark-to-market regime under section 1256 will apply to a section 988 transaction that is part of a hedging transaction and described in regulations to be issued under section 988 by the Secretary. Further, as described above, the general rule that treats foreign currency gain or loss as ordinary gain or loss is inapplicable to a section 1256 contract that is marked to market (sec. 421 of the bill requires such gain or loss to be treated as short-term capital gain or loss). The exception for section 1256 contracts is available to taxpayers who take such contracts off the mark-to-market system by making a mixed straddle election under section 1256(d); in a such case, as under present law, section 988 will not apply to any position and all of the positions in the mixed straddle will generate only short-term capital gain or loss. In connection with the exception for section 1256 contracts, the committee desires to make clear that bank forward contracts with maturities longer than the maturities ordinarily available for regulated futures contracts are within the definition of a foreign currency contract in section 1256(g), if the requirements of that subsection are satisfied otherwise.

Clarification of application of loss deferral rule

The bill clarifies that an obligor's interest in a foreign currency denominated obligation is a "position" for purposes of the loss deferral rule. The rationale for this treatment is that a foreign currency borrowing is economically equivalent to a short position in the foreign currency. In addition, the bill makes clear that foreign currency for which there is an interbank market is presumed to be "actively traded" property for purposes of the loss deferral rule.

Repeal of special rule for banks

The bill repeals the special rule that permits banks to qualify for the hedging exception to the straddle provisions without establishing all of the facts that other taxpayers must show.

4. Foreign currency translation

Under the bill, the same translation rule applies to the earnings and profits of a foreign corporation and the income or loss of a branch. An entity that uses a functional currency other than the U.S. dollar is required to use a profit and loss method to translate income or loss into U.S. dollars, at the appropriate exchange rate for a taxable year. The bill provides that the translation of pay-

ments of, and subsequent adjustments to, foreign taxes by a branch will be performed under the same rules that apply in determining the foreign tax credit allowable to a parent corporation with respect to taxes paid by a foreign subsidiary.

Application of section 905

The bill provides that, for purposes of applying section 905(c), the determination of whether accrued taxes when paid differ from the amounts claimed as credits by the taxpayer is made by reference to the functional currency of the qualified business unit that accrued and paid the taxes. Thus, exchange rate fluctuations with respect to a functional currency will not be taken into account under section 905(c).

Translation of branch income and losses

Translation of taxable income or loss

Under the bill, a taxpayer with a branch whose functional currency is a currency other than the U.S. dollar will be required to use the profit and loss method to compute branch income. Thus, the net worth method will no longer be an acceptable method of computing income or loss of a foreign branch for tax purposes, and only realized exchange gains and losses on branch capital will be reflected in taxable income.

For each taxable year, the taxpayer will compute income or loss separately for each qualified business unit in the business unit's functional currency, converting this amount to U.S. dollars using the weighted average exchange rate for the taxable period over which the income or loss accrued. This amount will be included in income without reduction for remittances from the branch during the year. The committee anticipates that regulations will provide rules that will limit the deduction of branch losses to the taxpayer's dollar basis in the branch (that is, the original dollar investment plus subsequent capital contributions and unremitted earnings).

A taxpayer will recognize exchange gain or loss on remittances (without regard to whether or when the remittances are converted to dollars), to the extent the value of the currency at the time of the remittance differs from the value when earned. Remittances of foreign branch earnings (and interbranch transfers involving branches with different functional currencies) after 1986 will be treated as paid pro rata out of post-1986 accumulated earnings of the branch. The committee anticipates that, for purposes of calculating exchange gain or loss on remittances, the value of the currency will be determined by translating the currency at the rate in effect on the date of remittance. Exchange gains and losses on such remittances will be deemed to be ordinary and domestic source.

Treatment of direct foreign taxes

The bill provides that adjustments to the amount of tax paid by a branch shall be translated into U.S. dollars using the same exchange rate used to translate the income inclusion with respect to which the adjustment is made. The rule for adjustments applies to increases in the amount of tax liability as well as refunds. For ex-

ample, assume a branch pays a tax of 100 Swiss francs in year one. In year two, the branch's tax liability is 50 francs, and the year one tax is adjusted downwards to 60 francs (so there was an overpayment of 40 francs). The 40-franc overpayment from year one is applied against the 50-franc liability for year two. In year three, the 50-franc tax paid in year two is refunded. On these facts, (1) regarding the reduction in the tax paid in year one, the 40 francs are translated at the exchange rate used to translate the earnings for year one, (2) regarding the crediting of the 40-franc overpayment against the 50-franc tax liability for year two, the entire 50-franc tax is translated at the same rate used to translate the earnings for year two, and (3) on refund of the year-two 50-franc tax in year three, the refund is translated at the same rate that was used to translate the earnings for year two.

Under the bill, a prepayment of a foreign tax (e.g., payments of estimated taxes or withheld taxes) is to be translated at the same exchange rate used to translate the income inclusion with respect to which the prepayment is made. A similar rule is to apply to installment payments of tax.

Example 7.—Assume that a domestic corporation organizes a foreign branch in year one. Assume further that the branch is a qualified business unit, and the branch's functional currency is K.

	Income	Foreign taxes	Exchange rate
Year 1	100K/$50	23K/$11.50	2K:$1
Year 2	100K/$80	23K/$18.40	1.25K:$1
Year 3	100K/$100	23K/$23	1K:$1

Year one.—Taxpayer has $50 of income, subject to tentative U.S. Tax of $16.50 (calculated at the 33-percent maximum corporate tax rate under the bill), and an offsetting FTC of $11.50. Net U.S. tax is $5.00.

Year two.—Taxpayer has $80 of income, subject to tentative U.S. tax of $26.40, and an offsetting FTC of $18.40. Net U.S. tax is $8.00.

Year three.—Taxpayer has $100 of income, subject to tentative U.S. tax of $33, and an offsetting FTC of $23. Net U.S. tax is $10.

Remittance of after-tax earnings in year three.—Under the bill, the remittance of 231K would trigger $53.90 of domestic source exchange gain (attributable to the difference between the current exchange rate and the rates in effect for the years in which earned), which is treated as ordinary income, with no offsetting foreign taxes:

1. 77K at 2K:$1 =$38.50 (difference of $38.50).
2. 77K at 1.25K$1: =$61.60 (difference of $15.40)
3. 77K at 1K:$1 =$77 (no difference).

Cumulatively, tentative U.S. tax liability is $93.69 (on total income of $230 plus $53.90), the offsetting FTC is $52.90, and the net U.S. tax is $40.79.

Foreign corporations

For purposes of determining the tax of any shareholder of a foreign corporation, the earnings and profits of the foreign corporation are to be determined in the corporation's functional currency. The bill codifies the result under the Bon Ami case by requiring taxpayers to use a common exchange rate to translate actual distributions, deemed distributions of subpart F income (sec. 922 of the bill expands the definition of subpart F income), or gain that is recharacterized as dividend income on the disposition of stock in a CFC or former CFC (sec. 622 of the bill amends the definition of a CFC), and foreign taxes deemed paid with respect thereto. The bill also clarifies the interaction of the foreign currency translation rules and the rules relating to adjustments to foreign taxes.

Translation of earnings and profits

On the distribution of earnings and profits from a 10-percent owned foreign corporation, a domestic corporation is required to translate such amounts (if necessary) at the current exchange rate on the date the distirubtion is included in income. Similarly, in the case of gain that is treated as a distribution of earnings under section 1248, the bill requires the deemed dividend to be translated (if necessary) at the current exchange rate on the date the amount is included in income. Thus, for actual distributions and deemed dividends under section 1248, no exchange gain or loss is recognized as the result of exchange rate fluctuations between the time earnings and profits arise and the time of distribution.

In the case of deemed distributions of subpart F income, as under present law, the required income inclusion is translated at the weighted average exchange rate for the foreign corporation's taxable year. Exchange gain or loss is recognized as the result of exchange rate fluctuations between the time of a deemed distribution and the time such previosly taxed income ("PTI") is actually distributed. Exchange gain or loss on distributions of PTI is to be treated as ordinary income or loss from or allocable to domestic sources. The Secretary is authorized to prescribe regulations for the treatment of distributions of PTI through several tiers of foreign corporations.

Treatment of deemed-paid foreign taxes

For purpose of determining the amount of foreign taxes deemed paid under sections 902 or 960, a foreign income tax paid by a foreign corporation is translated into U.S. dollars (if necessary) using the same exchange rate used to translate the income inclusion with respect to which such tax is deemed paid. Adjustments to the amount of tax paid by a foreign corporation are translated into U.S. dollars using the same exchange rate used to translate the income with respect to which the adjustment was made.

Foreign subsidiary with dollar functional currency

The bill contemplates that the rule of the *American Metal Co.* case will continue to apply to a foreign corporation whose function-

al currency is the U.S. dollar.[37] Thus, for example, for purposes of the indirect foreign tax credit, taxes paid by such a foreign corporation will be determined as of the date such taxes were paid or accrued.

Contiguous country corporations

Under Section 1504(d), a domestic corporation can elect to treat certain wholly owned subsidiaries organized under the laws of a contiguous foreign country (*i.e.*, Canada or Mexico) as domestic corporations. As a result of treatment as domestic corporations, these subsidiaries are included with the domestic parent corporation in the filing of a consolidated Federal income tax return. The result of a section 1504(d) election combined with use of the net worth accounting method is that gains and losses from contiguous country currency fluctuations are recognized on the U.S. tax return.

In many cases, the administrative burdens that an election under Section 1504(d) imposes on the taxpayer would not justify continuation of the election after the effective date of the provision prohibiting the use of the net worth method. Domestic corporations with foreign branches can avoid the adverse impact of switching to the profit and loss method by incorporating their branches; whereas this option is not available to contiguous country corporations that are treated as domestic corporations under Section 1504(d).

Consequently, the committee's bill contemplates that the Internal Revenue Service will allow corporations to elect out of their Section 1504(d) status as a result of the enactment of the provision requiring use of the profit and loss method.

This will diminish the administrative burdens for both taxpayers and the Internal Revenue Service, eliminate the need for changing the ownership structure in these corporations, and place those corporations on an equal footing with corporations operating foreign branches. As under present law, the revocation of a section 1504(d) election will (1) trigger excess loss accounts, if any, under Treasury regulations section 1.1502-19, (2) implicate the rules for recapture of foreign losses under section 904(f), and (3) be subject to the rules of section 367(a), among other applicable rules.

The committee intends that any procedure adopted by the Service will contain appropriate safeguards to limit recognition of exchange loss upon such election.

5. Other issues

In general, the Secretary is authorized to issue such regulations as may be necessary to carry out the purposes of the new rules for foreign currency transactions, including regulations (1) setting forth procedures to be followed by taxpayers with qualified business units using a net worth method of accounting before enactment of subpart J, to prevent a mismatching of exchange gain and loss, (2) limiting the recognition of foreign currency loss on remittances from qualified business units (to prevent the selective recognition of exchange losses), and (3) providing for the recharacterization of interest and principal payments with respect to obligations

[37] 221 F. 2d 134 (2d Cir. 1955) (when a foreign corporation keeps its books in U.S. dollars, foreign taxes are translated as of payment date).

denominated in hyperinflationary currencies.[38] The bill contemplates that the Secretary will also issue regulatory rules providing for the treatment of U.S. branches of foreign persons (addressing issues such as the extent to which exchange gain or loss on remittances are treated as effectively connected with a U.S. trade or business).

Effective Date

These provisions are effective for taxable years beginning after December 31, 1986.

Revenue Effects

These provisions are estimated to have a negligible effect on budget receipts.

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[38] The committee is aware of tax shelters that are premised on the creation of debt denominated in a hyperinflationary currency. For example, in one transaction, a U.S. partnership entered into an agreement with a Brazilian Sociedade civil limitada for the performance of services in Brazil. Payment was to be made in cruzeiros on a deferred basis, beginning seven years *after* the services were performed. The taxpayers involved took the position that the foreign currency account payable could be accrued currently by the U.S. partnership, even though the actual U.S. dollars required seven years hence will be much less than the U.S.-dollar value of the amount accrued. In this transaction, stated interest was 11% per annum, which might be adequate for a dollar borrowing but is below market when compared to the analogous AFR for cruzeiros. Thus, the committee concluded that the Secretary has adequate authority to treat this transaction in accordance with its economic substance under the rules relating to below market loans (*See* Prop. Treas. reg. sec. 1.7872-11(f)). Nevertheless, the committee determined that the Secretary should be granted additional regulatory authority to ensure that such transactions are properly characterized under Federal tax laws, a part from whether stated interest is adequate when measured in a foreign currency.

G. Tax Treatment of Possessions (Secs. 944 and 971-977 of the bill and secs. 32, 48, 63, 153, 246, 338, 864, 876, 881, 882, 931-936, 934A, 957, 1402, 1442, 6091, 7651, 7654, and 7655 of the Code)

Present Law

Overview

The income tax laws of the United States are in effect in Guam, the Commonwealth of the Northern Mariana Islands ("CNMI"), the U.S. Virgin Islands, and American Samoa as their local income tax systems. These jurisdictions are termed "possessions" of the United States for tax purposes. To transform the Internal Revenue Code of 1954, as amended ("the Code"), into a local tax code, each possession, in effect, substitutes its name for the name "United States" where appropriate in the Code. The possessions generally are treated as foreign countries for U.S. tax purposes. Similarly, the United States generally is treated as a foreign country for purposes of possessions taxation. Although this word-substitution system, known as the "mirror system", applies to Guam, the CNMI, the Virgin Islands, and American Samoa, the U.S. tax relationship with each possession is governed by somewhat different rules, as described below.

Guam

Under the Organic Act of 1950, Guam currently employs the mirror system of taxation. Under Code section 935, an individual resident of the United States or Guam is required to file, with respect to income tax liability to those jurisdictions, only one tax return—with Guam if the taxpayer is a Guamanian resident on the last day of the taxable year, or with the United States if the taxpayer is a U.S. resident on the last day of the year (the "single filing rule"). Withheld and estimated income taxes paid to the jurisdiction in which a return is not filed may be claimed as a credit against tax imposed by the jurisdiction of filing. In addition, with respect to taxation of U.S. and Guamanian citizens and resident individuals (but not corporations), the United States is treated as part of Guam for purposes of Guamanian taxation, and Guam is treated as part of the United States for purposes of U.S. taxation.

A corporation chartered in Guam that receives U.S. source income (other than certain passive income) must file a U.S. return and pay U.S. tax on that income. Under Code section 881(b), a Guamanian corporation is not treated as a foreign corporation for purposes of the 30-percent withholding tax on certain passive income paid to foreign corporations if (1) less than 25 percent in value of its stock is owned by foreign persons, and (2) at least 20 percent of its gross income is derived from sources within Guam.

Under U.S. law, Guam is authorized to impose up to a 10-percent surtax on income tax collected under the mirror system and may provide for rebates of mirror system taxes in certain circumstances.

Code section 936, which provides an incentive for U.S. corporations to invest in certain possessions, applies to Guam. In effect, a section 936 corporation operating in a possession such as Guam enjoys an exemption from all U.S. tax on the income from its business activities and qualified investments in that possession. To qualify for this treatment, the section 936 corporation must meet two conditions: (1) at least 80 percent of its gross income for the three-year period immediately preceding the close of the taxable year must be from sources within the possession; and (2) at least 65 percent of its gross income for that period must be from the active conduct of a trade or business in that possession.

Federal statutes do not permit Federal employers to withhold territorial income taxes. However, under Code section 7654, the United States generally covers over (i.e., transfers) to the treasury of Guam certain tax collected from individuals on Guamanian source income and withholding tax on Federal personnel employed or stationed in Guam. Similarly, Guam covers into the treasury of the United States certain tax collected from individuals on U.S. source income.

Banks organized in Guam are subject to tax on interest on U.S. Government obligations on a net basis.

CNMI

As of January 1, 1985, the CNMI is required to implement the mirror system in substantially the same manner as the mirror system is in effect in Guam. Code references to Guam are deemed to include the CNMI. Thus, the single filing rule for individuals under Code section 935 and the special withholding tax rule for interest and other passive income earned by corporations under section 881(b) also apply to the CNMI. In addition, U.S. law provides that the CNMI by local law may impose additional taxes and permit tax rebates, but only with respect to taxes on local source income.

Virgin Islands

Under the Naval Appropriations Act of 1922, the income tax laws of the United States, as amended, are held to be "likewise in force in the Virgin Islands", except that the proceeds of the income tax are paid into the treasury of the Virgin Islands. The courts have interpreted this provision to establish a mirror system of taxation in the Virgin Islands.

Under section 28(a) of the Revised Organic Act of the Virgin Islands, as interpreted by the courts, an "inhabitant" of the Virgin Islands is exempt from U.S. tax as long as the inhabitant pays tax to the Virgin Islands on its worldwide income. The term "inhabitant", for these purposes, has generally been interpreted to include individual residents of the Virgin Islands, corporations organized under the laws of the Virgin Islands, and corporations not organized under the laws of the Virgin Islands if such corporations

have contacts with the Virgin Islands sufficient to establish "residence" in the Virgin Islands.

Notwithstanding section 28(a) of the Revised Organic Act, Virgin Islands corporations, which are generally treated as foreign corporations, are liable for the U.S. 30-percent withholding tax on certain payments to foreign corporations. Under Code section 881(b), however, a Virgin Islands corporation is not treated as a foreign corporation for purposes of this tax if (1) less than 25 percent in value of its stock is owned by foreign persons, and (2) at least 20 percent of its income is derived from sources within the Virgin Islands.

Under Code section 934, the Virgin Islands generally is prohibited from reducing or rebating taxes imposed under the mirror system, with the following exceptions: (1) the prohibition does not apply (with respect to taxes on certain income derived from Virgin Islands sources) in the case of a full-year Virgin Islands resident individual; and (2) the prohibition does not apply (with respect to taxes on non-U.S. source income) in the case of a Virgin Islands or U.S. corporation which derives at least 80 percent of its income from Virgin Islands sources and at least 65 percent of its income from a Virgin Islands trade or business. Code section 936, which provides an incentive for U.S. corporations to invest in certain possessions, does not apply to investment in the Virgin Islands. Code section 934(b), in conjunction with section 28(a) of the Revised Organic Act, however, provides similar results. Under Code section 934A, the 30-percent withholding tax on certain payments to foreign persons (including U.S. persons), as imposed under the Virgin Islands mirror system, applies to payments to U.S. persons at a reduced 10-percent rate (which may be further reduced by the Virgin Islands).

The Virgin Islands is authorized to impose up to a 10-percent surtax on the mirror system tax. Otherwise, the Virgin Islands does not have the power to impose local taxes on income.

American Samoa

Unlike the possessions described above, U.S. law permits American Samoa to assume autonomy over its own income tax system. In 1963, however, American Samoa adopted the U.S. Internal Revenue Code as its local income tax. While American Samoa has the power to modify the Code for purposes of American Samoa's territorial tax, this authority has been exercised on only a few occasions, generally to adapt the Code to the needs of American Samoa.

Under section 931, U.S. citizens who receive 80 percent or more of their gross income from sources within American Samoa and 50 percent or more of their gross income from the conduct of a trade or business in American Samoa are exempt from U.S. tax on income derived from sources without the United States. In addition, Code section 936 applies to qualifying U.S. corporations doing business in American Samoa.

Reasons for Change

The Internal Revenue Code, with all its complexities, is designed primarily to tax income in the highly developed U.S. economy. The

mirror system, which entails imposing the Code in its entirety as local law, may be wholly inappropriate for the island economies of the U.S. possessions. The possessions need tax systems that help them to pursue development policies and to exercise greater control over their own economic welfare.

The frequency and extent of revisions to the Code in recent years have highlighted the problems inherent in the mirror systems. For example, in the possessions, a large portion of the revenue is collected from individuals in the lower tax brackets. Typically, the portion of local revenues collected from corporations and higher-income individuals is very small. Thus, revisions to the Code that lower the tax rates on individuals (such as the rate reductions enacted by the Economic Recovery Tax Act of 1981 and those contained in this bill) could have a substantial adverse effect on the possessions. In addition, revenue-neutral proposals that compensate for lowering tax rates by broadening the tax base may well not be revenue neutral in a possession where relatively little tax is collected from corporations or higher-income individuals.

The present mirror systems are very complex and the possessions often lack the resources to enforce these mirror systems effectively. Because of the difficulties of enforcement and the ambiguities and inconsistencies inherent in the mirror system, U.S. taxpayers may seek to abuse the mirror systems.

Therefore, to promote fiscal autonomy of the possessions, it is important to permit each possession to develop a tax system that is suited to its own revenue needs and administrative resources. It is also important to coordinate the possessions' tax systems with the U.S. tax system to provide certainty and minimize the potential for abuse.

The deficiencies in the current mirror systems of taxation afflict each possession, though in differing respects. The close economic relationship between Guam and the CNMI has given rise to mirror system problems resulting, in some cases, in harsh consequences for residents of Guam. With respect to the CNMI, the mirror system of taxation went into full force for the first time in 1985. The CNMI has repeatedly voiced its concern that it lacks the resources to administer and enforce the complex mirror system. In addition, American Samoa has had difficulty collecting tax from U.S. Government employees because the United States lacks authority to withhold American Samoan tax from wages.

With respect to the Virgin Islands, the interaction of the Internal Revenue Code with the Virgin Islands Revised Organic Act and the mirror system gives rise to numerous areas of ambiguity and problems of interpretation. These technical difficulties make administration of the law problematic, creating a climate of uncertainty for investors, and raising the possibility of unintended tax benefits for some and harsh consequences for others.

In particular, application of the ambiguous "inhabitant" rule of the Revised Organic Act has fostered tax avoidance and tax evasion schemes. A recent case leaves open the possibility that the interaction of V.I. and U.S. tax law exempts from all tax, in both the United States and the Virgin Islands, U.S. source income earned by a U.S. corporation qualifying as a V.I. inhabitant. This case raises "the prospect of the ultimate tax shelter." *Danbury* v.

United States, 57 AFTR 2d 86-669 (D.V.I. 1986). There is no case to be made for the proposition that Congress wittingly opened "the ultimate tax shelter" for taxpayers who chose to route their investments through the Virgin Islands. The inhabitant rule was designed to coordinate the U.S. and V.I. tax systems. The incoherence of a coordinating system that allows U.S. income earned by a U.S. person to escape all tax has caused the committee to repeal the inhabitant rule for all open years.

The committee has sought to respect the choice of each insular area in developing this legislation. While the committee believes it is appropriate to provide more local autonomy to these possessions, the committee does not intend to allow them to be used as tax havens. The committee believes that it may be appropriate for these possessions to reduce tax on local income in some cases, but the committee has included anti-abuse rules to prevent use of these possessions to avoid U.S. tax. The complexity and ambiguity of the present law rules have provoked taxpayers to take return positions that, while plausible under a literal reading, would result in tax avoidance beyond what taxpayers would ask from this committee or from Congress. The committee is seeking to prevent this in the future.

Explanation of Provisions

Overview

The bill eliminates the requirement that there be a mirror system of taxation in Guam and the CNMI, coordinates the tax systems of those possessions and of American Samoa with the U.S. tax system, and reforms the mirror system in the Virgin Islands. The treatment of the Virgin Islands reflects extended discussions between representatives of the Virgin Islands and the Treasury. It differs from the treatment of the other possessions because of the unique history of the relationship between the Virgin Islands and the United States.

1. Guam, the CNMI, and American Samoa

Guam, the CNMI, and American Samoa generally are granted full authority over their own local income tax systems, with respect to income from sources within, or effectively connected with the conduct of a trade or business within, any of these three possessions and with respect to any income received or accrued by any resident of any of these three possessions. This grant of authority is effective, however, only if and so long as an implementing agreement is in effect between the possession at issue and the United States which provides for (1) eliminating double taxation of income by the possession and the United States; (2) establishing rules for the prevention of evasion or avoidance of U.S. tax; (3) the exchange of information between the possession and the United States for purposes of tax administration; and (4) resolving other problems arising in connection with the administration of the tax laws of such possession and the United States. Any implementing agreement is to be executed on behalf of the United States by the Secretary of the Treasury after consultation with the Secretary of the Interior. Thus, as is currently the case with respect to American

Samoa, each of these possessions could adopt a mirror system as its local law if desired.

The committee does not intend that any of these insular areas afford any opportunities for tax avoidance. In particular, the committee does not intend that U.S. agreements with these possessions offer tax advantages beyond those, described below, available in the Virgin Islands.

The bill imposes two requirements on these insular areas. First, it provides that the amount of revenue received by Guam, American Samoa, or the Northern Mariana Islands pursuant to its tax laws during the first fiscal year in which the bill generally takes effect (after conclusion of an implementing agreement) and each of the four fiscal years thereafter shall not be less than the revenue (adjusted for inflation) that possession received pursuant to its tax laws for the last fiscal year before implementation of the bill's rules. Second, the bill provides that nothing in any tax law of Guam, American Samoa, or the Northern Marianas may discriminate against any citizen or resident of the United States or of any other possession.

If the Secretary of the Treasury, after consultation with the Secretary of the Interior, determines that any of these three possessions has failed to comply with either the revenue maintenance requirement or the nondiscrimination requirement, the Secretary is to notify the Governor of that possession in writing. If the possession does not comply with that requirement within 90 days of notification, the Secretary is to notify Congress of the noncompliance. Thereupon, unless the Congress by law provides otherwise, the mirror system of taxation (that is, the provisions of law in effect before the date of enactment of this Act that apply the provisions of the income tax laws of the United States as in effect from time to time to a possession of the United States) shall be reinstated in that possession, and shall be in full force and effect for taxable years beginning after the notification to Congress. If the failure to comply with the revenue maintenance requirement is for a good cause and does not jeopardize the fiscal integrity of the possession, the Secretary may waive that requirement for the period that he determines appropriate. There is to be no waiver of the nondiscrimination requirement.

Under present law, the tax system of the Mariana Islands depends on the system in force in Guam. The bill provides that the Northern Mariana Islands are free to continue present law or to choose the tax regime described in the bill without regard to any action that Guam might take.

An individual who is a bona fide resident of Guam, American Samoa, or the CNMI during the entire taxable year is subject to U.S. taxation in the same manner as a U.S. resident. However, in the case of such an individual, gross income for U.S. tax purposes does not include income derived from sources within any of the three possessions, or income effectively connected with the conduct of a trade or business by that individual within any of the three possessions. Deductions (other than personal exemptions) and credits properly allocated and apportioned to such excluded income will not be allowed for U.S. tax purposes. Thus, even a bona fide resident of Guam, the CNMI, or American Samoa is required to file a

U.S. return and to pay taxes on a net basis if he receives income from sources outside the three possessions (i.e., U.S. or foreign source income). However, a U.S. return is not required to be filed if the possession resident's non-possession source income is less than the amount that gives rise to a filing requirement under generally applicable U.S. rules. The United States will cover over to the treasuries of Guam, American Samoa, or the CNMI all U.S. income tax paid by a bona fide Guamanian, Samoan, or CNMI resident. It is anticipated that the possessions will identify these residents to the IRS in the manner currently done by the Virgin Islands. The committee does not intend that the insular areas grant any taxpayer a tax rebate or other benefit based upon those or any other covered-over taxes, which are attributable to non-possessions income.

Amounts paid to a bona fide resident of Guam, the CNMI or American Samoa for any services as an employee of the United States (including pensions, annuities, and other deferred amounts received on account of such services) are not treated as possessions source income, so they are fully taxable by the United States. The U.S. tax on these amounts is to be covered over to the treasury of the possession where the recipient resides, thus providing the possession with the same amount of revenue it currently receives. Withholding on the compensation of U.S. military personnel, stationed or resident in Guam, the CNMI, and American Samoa, will be covered over to the Treasuries of Guam, the CNMI, and American Samoa, as appropriate. No change in the current method of covering over these funds to Guam or the CNMI is anticipated so long as the existing mirror system continues in effect.

The bill delegates to the Secretary of the Treasury the authority to prescribe regulations to determine whether income is sourced in, or effectively connected with the conduct of a trade or business in, one of these possessions, and to determine whether an individual is a resident of one of these possessions. The committee anticipates that the Secretary will use this authority to prevent abuse. For example, the committee does not believe that a mainland resident who moves to a possession while owning appreciated personal property such as corporate stock or precious metals and who sells that property in the possession should escape all tax, both in the United States and the possession, on that appreciation. Similarly, the committee does not believe that a resident of a possession who owns financial assets such as stocks or debt of companies organized in, but the underlying value of which is primarily attributable to activities performed outside, the possession should escape tax on the income from those assets. The Secretary should treat such income as sourced outside the possession where the taxpayer resides (and any covered over taxes attributable to this income should not be rebated to the taxpayer). Similarly, where appropriate, the Secretary may treat an individual as not a bona fide resident of a possession.

The bill also provides rules which relieve a bona fide resident of Guam, the CNMI or American Samoa from being considered a U.S. person for purposes of applying certain reporting and taxation rules under subpart F with respect to corporations incorporated in Guam, the CNMI, or American Samoa if: (1) at least 80 percent or more of the corporation's gross income for a preceding three-year

period was from sources in, or effectively connected with the conduct of a trade or business in, the possession, and (2) at least 50 percent or more of the corporation's gross income for such period was derived from the conduct of an active trade or business in such possession.

Code section 881(b) is modified to provide that a Guamanian, CNMI, or American Samoan corporation will not be exempt from the 30-percent withholding tax unless (1) less than 25 percent in value of the corporation's stock is beneficially owned by foreign persons; (2) at least 65 percent of the corporation's income is effectively connected with the conduct of a trade or business in a U.S. possession or in the United States; and (3) no substantial part of the income of the corporation is used (directly or indirectly) to satisfy obligations to persons who are not bona fide residents of one of these three possessions, the Virgin Islands, or the United States. This exception from withholding also applies with respect to corporations organized in the U.S. Virgin Islands.

Local taxes of Guam, the CNMI, and American Samoa will be creditable for U.S. tax purposes if such taxes qualify as creditable taxes under the applicable foreign tax credit regulations.

The bill repeals the rule that subjects Guamanian banks to net basis taxation of interest on U.S. Government obligations (bill sec. 944). Thus, any Guamanian bank will be exempt from U.S. tax on this income, unless it becomes subject to the anti-conduit rules that apply to Guamanian corporations.

2. Virgin Islands

An individual qualifying as a bona fide Virgin Islands resident as of the last day of the taxable year will pay tax to the Virgin Islands under the mirror system on his or her worldwide income. He or she will have no final tax liability for such year to the United States, as long as he or she reports all income from all sources and identifies the source of each item of income on the return filed with the Virgin Islands. Any taxes withheld and deposited in the United States from payments to such an individual, and any estimated tax payments properly made by such an individual to the United States, will be covered over to the Virgin Islands Treasury, and will be credited against the individual's Virgin Islands tax liability. A Virgin Islands resident deriving gross income from sources outside the Virgin Islands will report all items of such income on his or her Virgin Islands return. Information contained on these returns will be compiled by the Virgin Islands Bureau of Internal Revenue and transmitted to the Internal Revenue Service to facilitate enforcement assistance.

Under the bill, for purposes of determining the tax liability of individuals who are citizens or residents of the United States or the U.S. Virgin Islands, the United States will be treated as including the Virgin Islands (for purposes of determining U.S. tax liability), and, under the Virgin Islands "mirror" Code, the Virgin Islands will be treated as including the United States (for purposes of determining liability for the Virgin Islands tax). A corporation organized in one jurisdiction, however, will continue to be treated, where relevant, as a foreign corporation for purposes of individual income taxation in the other jurisdiction.

A citizen or resident of the United States (other than a bona fide Virgin Islands resident) deriving income from the Virgin Islands will not be liable to the Virgin Islands for any tax determined under the Virgin Islands "mirror Code". Rather, in the case of such a person, tax liability to the Virgin Islands will be a fraction of the individual's U.S. tax liability, based on the ratio of adjusted gross income derived from Virgin Islands sources to worldwide adjusted gross income. Such an individual will file identical returns with the United States and the Virgin Islands. The Virgin Islands' portion of the individual's tax liability (if paid) will be credited against his total U.S. tax liability. Taxes paid to the Virgin Islands by the individual, other than the Virgin Islands portion of his U.S. tax liability, will be treated for U.S. tax purposes in the same manner as State and local taxes.

In the case of a joint return where only one spouse qualifies as a resident of the Virgin Islands, resident status of both spouses will be determined by reference to the status of the spouse with the greater adjusted gross income for the taxable year.

The Virgin Islands is provided with authority to enact nondiscriminatory local income taxes (which for U.S. tax purposes would be treated as State or local income taxes) in addition to those imposed under the mirror system.

The Secretary of the Treasury is given authority to provide by regulation the extent to which provisions in the Internal Revenue Code shall not apply for purposes of determining tax liability to the Virgin Islands (i.e., shall not be mirrored). It is anticipated that such regulations will provide that references to possessions of the United States will not be mirrored. In addition, the committee anticipates that these regulations will prevent abuses of the V.I. and U.S. tax systems such as that addressed by section 130 of the Tax Reform Act of 1984 (preventing tax-free payments of U.S. source income to foreign investors which arguably had been possible due to the interaction of the Revised Organic Act and the "mirror Code").

The bill provides that corporations operating in the Virgin Islands are eligible for the possession tax credit allowed under section 936.

The bill provides that the Revised Organic Act is treated as if it were enacted before the Code, so that in cases of conflict, the Code controls (sec. 975 of the bill). The bill specifies that the Revised Organic Act will have no effect on any person's tax liability to the United States. Thus, for example, even if a U.S. person is treated as an "inhabitant" of the Virgin Islands under the Revised Organic Act, that person will be fully subject to U.S. tax.

The authority of the Virgin Islands to reduce or rebate Virgin Islands tax liability is extended in some cases to apply to V.I. tax liability attributable to income that is not from U.S. sources and that is not effectively connected with the conduct of a trade or business in the United States. As for U.S. persons, however, and corporations 10-percent or more owned (directly or indirectly) by U.S. persons, the Virgin Islands can reduce or rebate tax only on income from V.I. sources or income effectively connected with a V.I. trade or business, although that right applies without regard to whether the affected taxpayer derives any minimum specified

percentage of its income from the Virgin Islands. Moreover, any authority to reduce or rebate taxes is conditioned upon the existence of an agreement between the United States and the Virgin Islands containing safeguards against the evasion or avoidance of United States income tax. The committee anticipates that such an agreement will contain measures coordinating the tax administration functions of the Internal Revenue Service and the Virgin Islands Bureau of Internal Revenue, as well as procedures for exchanging tax information.

This modification of the Virgin Islands' authority to reduce taxes applies only to non-U.S. source income, and income not effectively connected with the conduct of a U.S. trade or business, as those terms are defined under regulations prescribed by the Secretary for this purpose. The committee anticipates that the Secretary will use this authority to prevent abuse. For example, the committee does not believe that a mainland resident who moves to the Virgin Islands while owning appreciated personal property such as corporate stock or precious metals and who sells that property in the Virgin Islands should escape all tax, both in the United States and the Virgin Islands, on that appreciation. Similarly, the committee does not believe that a resident of the Virgin Islands who owns financial assets such as stocks or debt of companies organized in, but the underlying value of which is primarily attributable to activities performed outside, the Virgin Islands should escape tax on the income from those assets. The Secretary should treat such income as sourced outside the Virgin Islands. Similarly, where appropriate, the Secretary may treat an individual as not a bona fide resident of the Virgin Islands.

As noted above, the bill amends the exemption from the 30 percent withholding tax that applies under section 881(b) to possessions corporations, including Virgin Islands corporations. Under the bill, a Virgin Islands corporation will be exempt from withholding only if (1) less than 25 percent in value of the corporation's stock is owned by foreign persons; (2) at least 65 percent of the corporation's income is effectively connected with the conduct of a trade or business in a U.S. possession or in the United States, and (3) no substantial part of the income of the corporation is used (directly or indirectly) to satisfy obligations to persons who are not bona fide residents of one of the possessions or the United States. Thus, the exemption from the withholding tax will not be available for a corporation used as a conduit for payments to persons not resident in the Virgin Islands, the United States, or the other possessions.

Effective Dates

Guam, the CNMI, and American Samoa

The grants of authority to Guam and the CNMI, as well as the conforming changes to U.S. law, anti-abuse provisions, and administrative provisions, will be effective for taxable years beginning on or after the later of January 1, 1987 or the date an implementing agreement between the United States and the possession is in effect. The mirror codes currently administered by Guam and the CNMI will continue to operate, mutatis mutandis, as their respec-

tive local income tax laws, until and except to the extent that each possession takes action to amend its tax laws. The anti-abuse and administrative provisions with respect to American Samoa also are effective for taxable years beginning on or after the later of January 1, 1987 or the date an implementing agreement between the United States and the possession is in effect. The amendment to the rule taxing Guamanian banks on a net basis on income from U.S. Government obligations is effective for taxable years beginning after November 16, 1985.

Virgin Islands

The Virgin Islands provisions are generally effective for taxable years beginning on or after January 1, 1987. However, the repeal of the inhabitant rule applies to all open years. In addition, the provisions extending the right of the Virgin Islands to reduce the tax imposed on U.S. or V.I. corporations with respect to income from V.I. sources or income effectively connected with a V.I. trade or business, and the provisions creating the right of the Virgin Islands to reduce the tax imposed on V.I. corporations with respect to income from non-U.S. sources or income effectively connected with a non-U.S. trade or business, will become effective only when an agreement between the United States and the Virgin Islands to cooperate on tax matters becomes effective.

Implementing agreements

If an implementing agreement with any of the four possessions has not been executed within one year from the date of enactment, the Secretary is to report to the tax writing committees in detail the status of negotiations with that possession, and specifically why the agreement has not been executed. The committee intends that the report be forwarded promptly.

Revenue Effect

The provision is estimated to have a negligible effect on budget receipts.

TITLE X—INSURANCE PRODUCTS AND COMPANIES

A. Insurance Policyholders

1. Interest on Installment Payments of Life Insurance Products (sec. 1001 of the bill and sec. 101(d) of the Code)

Present Law

Amounts paid by an insurance company to the beneficiary of a life insurance contract by reason of the death of an insured individual generally are not includible in gross income. Under certain life insurance contracts, the insurer may agree to hold the amounts that it would otherwise pay on the death of the insured, and pay the life insurance proceeds at a later date.

If the insurer pays the insurance proceeds to a beneficiary in a series of payments after the death of the insured, a prorated amount of each payment is treated as a nontaxable payment of the death benefit, and the remainder of the payment generally is includible in gross income. However, the first $1,000 in excess of the amount treated as a payment of the death benefit received by a surviving spouse in any taxable year is excludable from gross income.

In addition, under present law, the amount held by an insurer with respect to any beneficiary is the amount that equals the value of the agreement, provided in the life insurance contract, to make payments at a date or dates later than the death of the insured. The value of such an agreement is determined as of the date of death of the insured and is discounted on the basis of the interest rate and mortality tables used by the insurer in calculating payments under the agreement. The mortality tables used by an insurer for purposes of valuing the agreement described above may distinguish among individuals on the basis of sex.

Reasons for Change

The amount received by a beneficiary of a life insurance contract in excess of the prorated amount deemed to be a payment of the death benefit represents a payment made by the insurance company for the use of the beneficiary's money, i.e., the unpaid death benefit. The committee believes that this amount is comparable to interest paid by other financial institutions for the use of depositors' money, and should be taxed in the same manner.

The committee is also concerned that insurance companies generally may distinguish among individuals on the basis of sex in calculating the amount of any payment that is deemed to be attributable to a death benefit. In most cases under the Internal Revenue Code, gender-neutral mortality tables are prescribed by the Secretary of the Treasury. The committee finds it appropriate to direct

the Secretary to prescribe a similar gender-neutral table for purposes of valuing the delayed payment of a death benefit.

Explanation of Provision

Under the bill, all amounts paid to any beneficiary of a life insurance policy at a date later than the death of the insured are included in gross income to the extent that the amount paid exceeds the amount payable as a death benefit. The exclusion from the gross income of the surviving spouse of the first $1,000 in excess of the amount payable as the death benefit is repealed.

The bill also requires, for purposes of valuing the portion of any payment deferred beyond the death of the insured that is a nontaxable death benefit, that an insurer use mortality tables prescribed by the Secretary of the Treasury in regulations. The committee expects that such tables will not distinguish among individuals on the basis of sex. An insurer would, therefore, no longer be permitted to use its own mortality table in determining the portion of any payment attributable to a nontaxable death benefit. As under present law, the insurer is to use the interest rate it uses in calculating payments under the agreement.

The operation of this rule does not prevent an insurance company from making payments to beneficiaries based on its own mortality tables. Rather, the provision operates to specify the portion of any installment payment that is to be treated as a payment of an excludable death benefit and the portion attributable to interest.

Effective Date

This provision applies to amounts received with respect to deaths occurring after December 31, 1986, in taxable years ending after that date.

Revenue Effect

The revenue effect of this provision is included with item 2., below.

2. Treatment of Structured Settlement Agreements (sec. 1002 of the bill and sec. 130 and new sec. 197 of the Code)

Present Law

Present law excludes from income the amount of any damages received on account of personal injuries or sickness, whether by suit or agreement and whether as a lump sum or as periodic payments. The person liable to pay the damages may assign to a third party (a structured settlement company) the obligation to make the periodic payments.

The portion of the amount received by the structured settlement company agreeing to a "qualified assignment" that is used to purchase qualified funding assets to fund the liability is not included in the company's income. Present law provides that the basis of a qualified funding asset is reduced by the amount excluded from gross income on account of the purchase of the asset. On disposition of a qualified funding asset, the gain recognized is treated as

ordinary income. However, periodic payments made by the structured settlement company to the injured party are deductible. The net effect of the use of a structured settlement agreement is to permit a taxpayer liable for damages to an injured party to deduct the amount of the damages as if they were paid in a lump sum and to permit a structured settlement company to exclude from income the earnings on amounts used to fund its liability to make periodic payments to the injured party.

Present law defines a qualified funding asset to mean any annuity contract if (1) the contract is used to fund periodic payments under a qualified assignment, (2) the payments under the annuity contract are reasonably related to, and do not exceed the amount of, the payments under the qualified assignment, (3) the contract is designated by the taxpayer as attributable to the specific qualified assignment and (4) the contract is purchased not more than 60 days before, and not more than 60 days after, the qualified assignment.

A qualified assignment is the assignment of a liability to make periodic payments as damages for personal injury or sickness if (1) the assignee (i.e., the structured settlement company) assumes the liability from a person who is a party to the suit or agreement under which the liability arose, (2) the periodic payments are fixed and determinable as to time and amount, (3) the form or amount of the periodic payments cannot be altered by the recipient, (4) the assignee does not provide rights to the recipient greater than the rights of a general creditor, (5) the assignee does not assume a liability greater than the assignor's liability, and (6) the periodic payments are excludable from the recipient's gross income (under sec. 104(a)(2)).

Reasons for Change

The present treatment of structured settlements has the overall effect of exempting from taxation investment income earned on assets used to fund the periodic payment of damages.[1] The committee believes that this effect is unwarranted, because the goal of the structured settlement rules is not to exempt from the gross income of an assignee the amounts invested to fund the periodic damage payments. Rather, the rules were designed to clarify the treatment of, and to eliminate a tax disincentive (i.e., the delay of a deduction for damage payments by the liable party) to, making periodic damage payments.

Although the committee recognizes and approves the goal of eliminating this disincentive for periodic payment of damages, the committee believes a more rational system will permit a liable party to elect to treat the purchase of an annuity to fund its liabilities as a deductible expense.

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[1] By contrast, if a party liable for damage payments does not assign the liability in a structured settlement arrangement, income on amounts used to fund periodic payments of damages is subject to tax; and investment income earned on lump-sum settlements is taxed to the recipient.

Explanation of Provision

The bill repeals the special treatment of structured settlement agreements and replaces those rules with a new deduction election for a taxpayer assuming a liability to make damage payments to an injured party.

Under the bill, in the case of a qualified assignment (as defined in present law) of a liability to a structured settlement company, a deduction is allowed to the assignee equal to the aggregate cost of any qualified funding assets acquired during the taxable year if the assignee elects to have this provision apply. The structured settlement company, which assumes the liability for such damage payments, may not deduct amounts under this provision other than the cost of acquiring the qualified funding asset (as defined in present law). Thus, payments to the recipient of the damage payments are not deductible by the company.

The structured settlement company's basis in any qualified funding asset is determined as if this provision had not been enacted. Thus, as the company receives periodic payments on the qualified funding asset and pays them over to the recipient of the damage payments, the amount includible in the company's income is the excess over its basis in the qualified funding asset. For example, in the case of an annuity contract, the amount includible generally is the excess over the investment in the contract. An election by the structured settlement company to have this provision apply is to be made on the company's tax return for the taxable year in which the assignment occurs and, once made, cannot be revoked without the consent of the Secretary of the Treasury.

If, on the other hand, the structured settlement company does not elect to have this provision apply, then the amount received in consideration of assuming the liability is included in income without an offsetting deduction for the cost of a funding asset. Payments made to the third party pursuant to the structured settlement agreement are fully deductible when paid.

Effective Date

The provision is effective for assignments entered into in taxable years beginning after December 31, 1986.

Revenue Effect of Part A

The provisions of part A (items 1 and 2, above) are estimated to increase fiscal year budget receipts by less than $5 million per year.

B. Life Insurance Companies

1. Special Life Insurance Company Deduction (sec. 1011 of the bill and sec. 806 of the Code)

Present Law

A life insurance company is taxed at corporate rates on its life insurance company taxable income (LICTI) and certain other income. A life insurance company is allowed a special deduction in computing LICTI equal to 20 percent of the income from insurance businesses that otherwise would be subject to taxation (sec. 806(a)).

Reasons for Change

The 20-percent special life insurance company deduction was enacted in 1984 because it was believed necessary to ameliorate the sudden, substantial increase in the tax liability of life insurance companies. This increase occurred as a result of the change from the three-phase taxable income computation that was in effect previously to a single-phase system consistent with generally applicable corporate tax law. The provision was not intended to tax life insurance companies at generally lower tax rates than other corporations.

In light of the overall reduction of corporate tax rates contained in other provisions of the bill, the committee believes that the 20-percent special life insurance company deduction is no longer necessary. Despite the elimination of this special deduction, the maximum marginal tax rate applicable to life insurance companies will decline under the bill.

Explanation of Provision

The special life insurance company deduction is repealed. In addition, a special rule is provided in the case of a life insurance company owning the stock of another corporation through a partnership, which stock was acquired on January 14, 1981. For purposes of determining the small life insurance company deduction under section 806(a), tentative life insurance company taxable income is computed without taking into account income, gain, loss or deduction attributable to the ownership of such stock, and the amount of such income, gain, loss or deduction is taken into account as if the amendments to the corporate tax rates had not been enacted, but rather, present law rates remained in effect.

Effective Date

This provision is effective for taxable years beginning after December 31, 1986.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $391 million in 1987, $678 million in 1988, $729 million in 1989, $783 million in 1990, and $839 million in 1991.

2. Operations Loss Deduction of Insolvent Companies (sec. 1012 of the bill)

Present Law

Prior to 1984, life insurance companies were permitted to exclude from taxable income 50 percent of the excess of gain from operations over taxable investment income. In addition, life insurance companies were allowed certain special deductions for nonparticipating contracts and for accident and health insurance and group life insurance contracts. The amounts deducted under these provisions were added to a deferred tax account known as the policyholders surplus account (PSA). The allowance of these special deductions, and the establishment of a PSA, were intended to provide a cushion of assets to protect the interests of the policyholders. The 1984 Act repealed the deduction for additions to a PSA, but continued the deferral on existing amounts in a PSA.

The deferral of tax on existing amounts held in the PSA of a life insurance company is ended if the amounts are distributed to shareholders. In certain circumstances, amounts may be required to be distributed from the PSA (i.e., the deferral of tax on such amounts is ended) if the PSA becomes too large in relation to the scope of the company's current operations. The deferral of tax on amounts in the PSA also may end if the company ceases to be taxed as a life insurance company. The amounts included in income as a result of ending deferral on amounts in the PSA cannot be offset by the company's loss from operations or loss carryovers.

Reasons for Change

The committee believes that, in the limited case of a contraction of an insurance company's business due to insolvency on November 15, 1985, and the court-ordered liquidation of the company, it is appropriate to permit the otherwise unusable loss from operations or operations loss carryovers to offset the previously deferred amounts in the PSA. The committee believes this exception should be limited to this specific case in order to ensure that the tax otherwise due on a distribution from a PSA is collected.

Explanation of Provision

Under the bill, a life insurance company is permitted to apply its current loss from operations and its unused operations loss carryovers against the increase in its taxable income attributable to the amount distributed from its PSA if certain conditions are satisfied. First, the company must have been insolvent on November 15, 1985. Second, the company must be liquidated pursuant to the order of a court of competent jurisdiction in a title 11 or similar case. Third, as a result of the liquidation, the company's tax liabil-

ity must be increased due to distributions from the PSA. Under the provision, no carryover of any loss from operations of the company arising during or prior to the year of liquidation may be used in any taxable year succeeding the liquidation year (regardless of whether the amount of the loss exceeds the amount of the distribution from the PSA).

Effective Date

The provision applies to liquidations on or after November 15, 1985.

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by a negligible amount.

3. Treatment of Electing Mutual Life Insurance Company (sec. 217 of the Tax Reform Act of 1984 and sec. 1013 of the bill)

Present Law

Present law permits a mutual life insurance company to elect to treat all its individual noncancellable (or guaranteed renewable) accident and health insurance contracts as cancellable, for purposes of determining whether the company is a life insurance company. A company which has sufficient reserve amounts attributable to such contracts may be subject to tax as a property and casualty insurance company, rather than a life insurance company, as a result of making this election. As a condition of making this election, however, all stock life insurance company affiliates of an electing mutual life insurance company which is the common parent of the group are treated as mutual life insurance companies subject to tax under all provisions of the Code applicable to mutual life insurance companies, including the provisions regarding the differential earnings amount of mutual companies.

Reasons for Change

The committee believes that it is no longer appropriate to require that stock life insurance company affiliates of an electing mutual company be treated as mutual life insurance companies. Therefore, for taxable years beginning after 1986, the committee bill repeals the requirement associated with the election that stock life insurance affiliates of the electing mutual company be treated as mutual life insurance companies.

Explanation of Provision

The requirement under section 217(i) of the Tax Reform Act of 1984 that stock life insurance company affiliates of an electing mutual life insurance company common parent are treated as mutual life insurance companies is repealed.

Effective Date

The provision is effective for taxable years beginning after December 31, 1986.

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by a negligible amount.

C. Property and Casualty Insurance Company Taxation

1. Inclusion in Income of 20 Percent of Unearned Premium Reserve (sec. 1021 of the bill and sec. 832(b) of the Code)

Present Law

Under present law, the income of a property and casualty insurance company (whether stock or mutual)[2] includes its underwriting income or loss and its investment income or loss, as well as gains and other income items.[3] Underwriting income means premiums earned on insurance contracts during the year, less losses incurred and expenses incurred (sec. 832(b)(3)). To determine premiums earned, the increase in unearned premiums during the year is deducted from gross premiums (sec. 832(b)(4)(B)). This treatment of unearned premiums generally reflects accounting conventions imposed under applicable law[4] and corresponds to the establishment of reserves for unearned premiums.

Unearned premiums of a property and casualty insurance company include its life insurance reserves (including annuity reserves), if any. Generally, the deduction for the reserve for unearned premiums effects a deferral of the premium income attributable to insurance coverage in a future taxable year of a property and casualty company.

Property and casualty insurers may also deduct expenses incurred during the taxable year (sec. 832(b)(3)). Expenses incurred generally means expenses shown on the annual statement approved by the National Association of Insurance Commissioners. Expenses incurred are calculated by adding to expenses paid during the year the difference between unpaid expenses at the end of the current year and unpaid expenses at the end of the preceding year (sec. 832(b)(6)). Expenses incurred ordinarily include premium acquisition expenses. Expenses, to be deductible, must constitute ordinary and necessary trade or business expenses within the meaning of section 162 (sec. 832(c)(1)), although this rule does not determine the time when the deduction is allowed.

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[2] The use of the term "property and casualty insurance company" is intended to refer to all those taxpayers subject to tax under Part II or III of subchapter L of the Code.

[3] Under present law, mutual companies with certain gross receipts less than $150,000 are exempt from tax (sec. 501(c)(15)), and other rules set forth special rates, deductions, and exemptions for mutual companies with certain categories and amounts of income (sec. 821 et seq.). In addition, mutual companies are allowed a special deduction for additions to a bookkeeping protection against loss account (sec. 824). (See the separate discussion of the protection against loss account, at item C.3., below.)

[4] See National Association of Insurance Commissioners ("NAIC")-approved annual statement form (often called the yellow blank) used by property and casualty insurance companies for financial reporting. The accounting techniques used in preparing this annual statement are referred to as statutory accounting principles (SAP), and generally are more conservative than generally accepted accounting principles (GAAP) and the cash and accrual methods of tax accounting.

Reasons for Change

Present law permits a deferral of unearned premium income, while the expenses of earning the deferred income (e.g., premium acquisition expenses) may be deducted currently. Several proposals for tax reform in the area of property and casualty insurance have suggested that permitting a deferral of an undiscounted portion of unearned premium income while allowing a current deduction for associated costs of earning the deferred income produces a mismatching of income and expenses, and a resulting mismeasurement of income.[5] The committee has acted in this bill to provide a better matching of income and expenses by reducing the deduction for unearned premiums in a manner intended to reflect costs of earning the deferred amounts.

Explanation of Provision

General rule

Under the bill, a property and casualty insurance company generally is required to reduce its deduction for unearned premiums by 20 percent. This amount is intended to represent the allocable portion of expenses incurred in generating the unearned premiums. Thus, for taxable years beginning after 1986, only 80 percent of the increase in unearned premiums in each year is deductible. To the extent there is a decrease in the unearned premium reserve for a taxable year beginning after 1986, the resulting inclusion in income would be reduced; only 80 percent of the amount would be includible. Thus, if the taxpayer's unearned premium reserve increased in 1987 from $1,000 to $1,100, the net deduction for unearned premiums would be $80 ($1,100-1,000 x 80%). Similarly, if the unearned premium reserve declined in 1988 from $1,100 to $900, the taxpayer would be required to include $160, rather than $200, in income.

Life insurance reserves, as defined in section 816(b), that are included in unearned premium reserves under section 832(b)(4) are not subject to this reduction under the bill. Increases (or decreases) in such life insurance reserves remain 100 percent deductible (or, to the extent a decrease in unearned premium reserves is attributable to a decrease in life insurance reserves, 100 percent includible). This exception to the 80 percent rule is permitted because such life insurance reserves are calculated under sec. 807 in a manner intended to reduce the mismeasurement of income resulting from the mismatching of income and expenses.

Application of general rule to outstanding balances

The bill also provides for the inclusion in income of 20 percent of the unearned premium reserve outstanding at the end of the most recent taxable year beginning before January 1, 1987. This income

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[5] See General Accounting Office, *Congress Should Consider Changing Federal Income Taxation of the Property/Casualty Insurance Industry* (GAO/GGD-85-10), March 25, 1985 ("GAO Report"); tax reform proposals made by President Reagan ("The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity," May 1985, referred to as the "Administration Proposal"); the 1984 Treasury Department Report to the President ("Tax Reform for Fairness, Simplicity, and Economic Growth," November 1984, referred to as the "1984 Treasury Report").

is includible ratably over a seven and one-half year period commencing with the first taxable year beginning after December 31, 1986. In each of the first seven taxable years during this period, 2-2/3 percent of the unearned premium reserve outstanding at the end of the most recent taxable year beginning before January 1, 1987, is included in income and in the eighth year, 1-1/3 percent is included.

Special rule

In the case of insurance against default in the payment of principal or interest on securities with a maturity of 5 years or more, the deduction for increases in unearned premiums is reduced by 10 percent, rather than 20 percent. Thus, only 90 percent of the increase in unearned premiums is deductible and 90 percent of any decrease is includible in income. Insurance on securities with a maturity of less than 5 years is subject to the general rule reducing the deduction (or inclusion) for a change in unearned premiums by 20 percent.

With respect to the treatment of the outstanding balance of unearned premiums at the end of the most recent taxable year beginning before January 1, 1987, 1-1/3 percent of the outstanding balance is includible in each of the first 7 taxable years beginning after December 31, 1986, and 2/3 percent of such balance is includible for the eighth taxable year.

Companies that cease to be insurance companies

Under the bill, if a property and casualty insurance company ceases to be subject to parts II or III of subchapter L (including the rules relating to the treatment of unearned premiums), the rule for outstanding unearned premium balances (for balances as of the end of the last taxable year beginning before January 1, 1987) is applied to include the remaining amount subject to the rule in income for the taxable year preceding the taxable year in which the company ceases to be subject to tax as a property and casualty insurance company.

An exception is provided to the extent a successor company (which is also an insurance company) is subject to the requirements of section 381(c)(22). Further, this rule applies only if a company ceases to be a property and casualty company for a taxable year beginning before January 1, 1995.

For example, if a property and casualty insurance company has an outstanding unearned premium balance of $100 for its taxable year ending December 31, 1986, 20 percent of the unearned premium balance, or $20, is subject to the ratable inclusion rule. For its taxable year ending December 31, 1987, 2-2/3 percent of $100, or $2-2/3, is included in income. If the company ceases to be a property and casualty insurance company for its taxable year beginning January 1, 1989, then $17-1/3 is includible in income for the company's taxable year ending December 31, 1988.

The committee has adopted this rule because the treatment of the outstanding unearned premium balance is designed to avoid a substantial income inclusion in the first taxable year after the effective date. However, if a company ceases to be a property and casualty insurance company during the phase-in period, the com-

mittee believes the phase-in should be accelerated to prevent permanent avoidance of the income inclusion.

Effective Date

The provision is generally effective for taxable years beginning after December 31, 1986. The inclusion in income of 20 percent (10 percent for insurance on certain securities) of unearned premium reserves outstanding for the most recent taxable year beginning before January 1, 1987, takes effect ratably over the 7-1/2 taxable years beginning after December 31, 1986, and before January 1, 1994.

2. Loss Reserve Deductions (sec. 1022 of the bill and secs. 807, 832, and 846 of the Code)

Present Law

In general

Present law provides generally that property and casualty companies are required to include their underwriting and investment income or loss in taxable income (sec. 832(b)). Underwriting loss, if any, may offset investment income. Among the items that are deductible in calculating underwriting income are additions to reserves for losses incurred and for unearned premiums. Thus, generally, underwriting income is determined in a manner similar to the manner in which insurers account for underwriting income for statutory accounting purposes. Consequently, the deduction for losses incurred may include the amounts of contested liabilities, and amounts which are estimated (and which therefore may be subject to future change when the amounts can be determined with reasonable accuracy).

This method of tax accounting for losses differs from the rules generally applicable under the cash and accrual methods of accounting. Under the cash method, amounts representing allowable deductions are generally taken into account for the taxable year in which they are paid (Treas. Reg. sec. 1.461-1(a)(1)). Thus, under the cash method of accounting, unpaid losses would not be currently deductible.

Under the normal rules of accrual method tax accounting, the all-events test must be met, and economic performance generally must have occurred, before a deduction may be accrued. The all-events test provides that "an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy" (Treas. Reg. sec. 1.461-1(a)(2)). A contested liability may not be deducted unless the taxpayer has transferred money or other property beyond his control to provide for the satisfaction of the liability (sec. 461(f)). If the liability of the taxpayer requires the taxpayer to provide property, economic performance occurs as the property is provided by the taxpayer. In the case of workers' compensation and tort liabilities of the taxpayer requiring payments to another person, economic performance occurs as the payments are made. Thus, under the accrual method of accounting, contested liabilities and amounts which cannot yet be determined

with reasonable accuracy would not be currently deductible, and losses generally would not be deductible until the loss is paid.

Treatment of title insurance

Under present law, the treatment of title insurance (i.e., insurance to protect the buyer of real property against the risk that a defect in the title or an encumbrance against the property exists at the time the property is purchased) differs from the treatment normally accorded to property and casualty companies. The Internal Revenue Service had previously held that the provisions of the Code (sec. 832(b)(4)) relating to the division of premiums between earned and unearned was inapplicable to title insurance because title insurance company premiums are earned in full at the time the company's services are rendered.[6]

Subsequently, the IRS revoked its prior position with respect to cases in which a State statute regarding unearned premium reserves of title insurance companies requires that such premiums be placed in a reserve, withdraws them from the control of the company for use as general funds, and imposes a trust in favor of the policyholders for a period prescribed in such State statute.[7] Thus, for title insurers operating in jurisdictions requiring the maintenance of an unearned premium reserve, the IRS permitted premiums received by title insurers (to the extent of the reserve required under State law) to be treated as unearned premiums for Federal income tax purposes.

In 1983, the IRS revoked Rev. Rul. 71-598.[8] The Service noted that, in the case of a title insurance company, the loss against which the insurance is provided, i.e., the risk of defect in title or encumbrance to property, is mature at the time the policy is issued, so that premiums received are not unearned premiums. Further, the Service concluded that deducting both a State-law "unearned premiums" reserve and a loss reserve amount would take account of the same items twice. Therefore, to the extent that the State statute required a reserve in excess of those reserves necessary for the protection of policyholders, it is not appropriately treated as a deductible reserve amount.

Reasons for Change

The loss reserves currently taken into account for tax purposes, and for State regulatory reporting on the annual statement prescribed by the National Association of Insurance Commissioners ("NAIC"), are determined for the most part as the arithmetic sum of anticipated claims payments in future years. The committee believes that present law does not accurately measure the income of property and casualty insurers. Unlike other taxpayers, property and casualty insurance companies are permitted to deduct losses prior to the time the loss is paid or accrued. The committee believes that the present-law treatment of property and casualty com-

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[6] Rev. Rul. 70-245, 1970-1 C.B. 154, restating under the 1954 Code the position set forth in I.T. 2920, XIV-2 C.B. 255 (1935).

[7] Rev. Rul. 71-598, 1971-2 C.B. 261, citing *Early v. Lawyers Title Insurance Company*, 132 F.2d 42 (4th Cir. 1942).

[8] Rev. Rul. 83-174, 1983-2 C.B. 108.

panies thereby permits such companies to overstate the true current cost of the insured loss; the deduction for such losses is overstated by the amount by which the nominal dollar value of a loss exceeds the present value of the insurance company's liability to pay the resulting claim. The longer the period of time involved, the greater the overstatement. In other words, the failure of current law to reflect the time value of money permits these companies to understate their income.

The committee recognizes that the nature of the business of a property and casualty company affects the extent to which loss deductions are overstated. For example, some types of policies (such as medical malpractice or commercial liability policies) typically give rise to a long deferral period between occurrence of a loss and payment of a claim. These "long-tailed" losses receive the greatest benefit from the failure to take into account the time value of money. The committee believes that the tax treatment of loss reserve deductions has contributed to what is referred to as cash flow underwriting, in which a property and casualty company establishes a premium based on the assumption that investment income (which often is tax exempt) will offset underwriting losses.

The committee concludes that it is necessary to undertake a comprehensive restructuring of the tax treatment of loss reserve deductions for property and casualty insurance companies. The committee's bill modifies the timing and amount of loss reserve deductions to take account partially of the time value of money available currently under the property and casualty taxation provisions.

The committee bill adopts a pre-tax method of discounting similar to a method proposed by the General Accounting Office to reduce the loss reserve deductions of property and casualty companies. This method of discounting is dissimilar to the rules applicable to other taxpayers under which deductions for losses are allowed when economic performance occurs, and to methods of accounting that produce consequences economically equivalent to the economic performance rules (such as the special rules for nuclear decommissioning expenses contained in sec. 468A). The committee believes, however, that in order to acknowledge the effect of the time value of money, which is not reflected in present-law treatment of loss reserves, it is appropriate to adopt a method of discounting for such reserves.

Explanation of Provision

In general

The bill amends the relevant provisions of subchapter L to provide for the discounting of the deduction for loss reserves to take account partially of the time value of money. Thus, the bill limits the deduction for unpaid losses (reported losses that have not been paid, estimates of losses incurred but not reported and resisted claims, and unpaid loss adjustment expenses) to the amount of discounted unpaid losses (new sec. 846 of the Code). Any net decrease in loss reserves would result in income inclusion, as under present law, but computed on a discounted basis.

This modified treatment of loss reserve deductions is applicable both to loss reserves of property and casualty companies, and to

loss reserves of life insurance companies that are not required to be discounted under life insurance rules. In the case of any reserves (including reserves of property and casualty companies) which life insurance company provisions require to be discounted, the applicable life insurance reserve discounting rules apply in lieu of the new discounting rules adopted by the bill.

Special treatment under the bill is provided with respect to (1) certain types of accident and health insurance, including disability insurance, and (2) title insurance.

Scope of discounting

Under the bill, the deduction for losses incurred is computed in the following manner. The amount of losses paid during the taxable year is calculated, and is increased by salvage and reinsurance recoverable (attributable to paid losses) outstanding at the end of the preceding taxable year and is decreased by salvage and reinsurance recoverable (attributable to paid losses) outstanding at the end of the current taxable year. The amount of paid losses is increased by the amount of discounted unpaid losses (as defined in new sec. 846) outstanding at the end of the taxable year and is decreased by the amount of discounted unpaid losses outstanding at the end of the preceding taxable year.

Unpaid losses generally mean the amount of unpaid losses reflected on the annual statement approved by NAIC that the taxpayer is required to file with insurance regulatory authorities of a State. For purposes of calculating unpaid losses under the bill, unpaid loss adjustment expenses are treated as unpaid losses and are not included in the amount of expenses unpaid (under sec. 832(b)(6)). Unpaid losses are separately defined under the bill to include any unpaid loss adjustment expenses shown on the annual statement; unpaid loss adjustment expenses are not to be taken into account more than once. Under the bill, the Secretary of the Treasury is directed to provide, in regulations, for the proper treatment of salvage and reinsurance recoverable with respect to unpaid losses.

Lines of business to which discounting rules apply

The bill requires all property and casualty loss reserves (unpaid losses and unpaid loss adjustment expenses) for each line of business (as shown on the annual statement) to be discounted for tax purposes. The lines of business are categories for the reporting of claims and claim payments, and specifically appear on Schedules O and P of the annual statement for property and casualty companies (technically, the "fire and casualty" annual statement as prescribed by the NAIC).

The lines of business reported on Schedule O of the annual statement relate mostly to "short-tail" coverages, such as auto physical damage, although they also include accident and health coverages some of which involve the payment of claims over extended periods, such as so-called long-term disability coverages. "Short-tail" coverages or lines of business are lines of business in which the period of time between the occurrence of the loss for which cover-

age is provided and the payment of the claim attributable to that loss is, on average, relatively short.[9]

Two of the Schedule O lines are denominated "reinsurance" and "international," respectively, and include amounts that may optionally be reported in those lines or in other Schedule O and P lines to which the reinsurance or international insurance is directly allocable.

The Schedule P lines typically are longer-tail (primarily liability coverage) lines. The longer-tail lines of business are denominated in five annual statement categories: auto liability, other liability, workers' compensation, medical malpractice, and multiple peril (encompassing farm owners' multiple peril, homeowners' multiple peril, commercial multiple peril, ocean marine, aircraft (all perils), and boiler and machinery. Under the bill, the multiple peril lines of business are treated as a single line of business for purposes of applying the discounting provisions. A "long-tail" line of business is a line in which the time between the occurrence of a loss and the payment of a claim is fairly long. Some lines of business, such as workers' compensation and medical practice, have significantly longer tails, with a large percentage of claims remaining unpaid after 10 years.

In the case of insurers which hold loss reserves for cancellable accident and health ("A&H") coverages and are required by the bill to discount such reserves, the amounts involved typically are reported on Exhibits 9 and 11 of the NAIC annual statement for life and health companies.

Because of the presence of potentially longer-tail claims in the accident and health lines as well as in the reinsurance and international lines, the bill provides for special treatment with respect to these types of business, as described more fully below.

Discounting methodology

To implement the discounting of loss reserves, the bill provides that the deduction for unpaid losses is limited to the annual increase in discounted unpaid losses. The amount of the discounted unpaid losses as of the end of any taxable year attributable to any accident year is the present value of the losses (as of the close of the taxable year) determined by using (1) the gross amount to be subjected to discounting (i.e., the undiscounted loss reserves), (2) the pattern of payment of claims, including the duration in years over which the claims will be paid, and (3) the rate of interest to be assumed in calculating the discounted reserve.

This discounting methodology is applied by line of business and by accident year, as reported on the annual statement filed for the year. Under the bill, the term accident year means the year in which the incident occurs that gives rise to the related unpaid loss.

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[9] Whether a loss has occurred, and the time between occurrence and payment, depends on whether the insurance contract is written on a "loss incurred" or on a "claims made" basis. If insurance is provided on a "loss incurred" basis, coverage is provided with respect to losses that occur during the period of coverage. Alternatively, if a policy is written on a "claims made" basis, coverage is provided with respect to claims reported during the period of coverage. Typically, the time between occurrence of a loss and payment of a claim is shorter if policies are written on a claims made basis.

For this purpose, in the case of a claims made policy, the accident year will generally be the year in which the claim is made.

Limit on discounted losses.—The amounts to which the discounting rules are applied under the bill are the undiscounted loss reserves (as reported on the annual statement for the accident year with respect to the line of business to which the discounting applies). The relevant annual statement is the statement filed by the taxpayer for the fiscal year ending with or within the taxable year of the taxpayer.

In some cases (such as workers' compensation) for certain companies, the reserves shown on the annual statement are already discounted and identified as such. The committee intends that, in the case of a loss reserve that is discounted for purposes of annual statement reporting, the loss reserve for annual statement reporting is grossed up and an undiscounted loss reserve is calculated. This grossing up of discounted loss reserves to undiscounted loss reserves for Federal income tax purposes is available only if the discounting for annual statement reporting is identified as such, and the discounting factors that were used are explained, on the annual statement. It is not necessary that the disclosure of discounting be required on the annual statement, as long as the taxpayer actually discloses the fact that unpaid loss reserves are discounted and the basis for such discounting with its annual statement. This undiscounted loss reserve amount is used as the amount of unpaid losses from which the loss reserve discounting for tax purposes is computed.

However, the committee is concerned about the potential for abuse when a property and casualty insurance company computes undiscounted unpaid losses by grossing up any annual statement discounted losses. A company could overstate the undiscounted losses (by overstating the amount by which its unpaid losses are discounted). In such a case, the company could effectively negate the application of the income tax discounting requirements.

One way of dealing with this potential problem would be to require that the discounting rules applicable for income tax purposes be applied to the loss reserves reported on the annual statement, whether or not discounted. The committee believes, however, that such an approach would be inequitable because it would understate some companies' deduction compared to other companies that did not discount for financial reporting purposes. Rather than impose this type of detriment on companies that discount on their annual statements, and thereby possibly interfere with the regulatory authority of the States, the bill imposes a limitation on the ability of a property and casualty insurance company to overstate its discounting factors for annual statement reporting by providing that in no event can the amount of discounted loss reserves for Federal income tax purposes exceed the aggregate amount of unpaid losses (and loss adjustment expenses) with respect to any line of business for an accident year as reported on the annual statement. Further, the amount and rate of the discount, for annual statement purposes, for any line of business, must be ascertainable on the basis of information filed on or with the annual statement.

Discount factors

Under the bill, the tax reserve discount factors, computed using the assumptions described below (i.e., the interest rate and the loss payment pattern, including the maximum duration of payments), are to be separately developed for and applied to the unpaid loss attributable to each accident year for each line of business. Recognizing that the computations of the discount factors themselves involve a degree of complexity, it is anticipated that the Secretary will annually publish discount factors which taxpayers may use in determining the discounted amounts of their loss reserves.

Once a series of discount factors is applied to an accident year for a line of business, it continues to be used without change as that accident year "ages" (i.e., as the claims for that year proceed to be paid out). In effect, each line of business and accident year is vintaged under the discounting provision, and subsequent redeterminations of the interest rate or payment pattern for that vintage based on actual experience of a particular company or the industry in general are neither required nor permitted.

Interest rate.—The interest rate used for purposes of applying the discounting methodology to a line of business is 5 percent for all accident years of the company beginning before or in 1987. For accident years beginning after 1987, the annual interest rate applicable to the discounting of unpaid losses is equal to 75 percent of the average of the annual Federal mid-term rates (as defined in sec. 1274(d) converted to a rate based on annual compounding) effective as of the beginning of each of the calendar months in the base period. The base period means the most recent 60 calendar months ending before the beginning of the calendar year for which the determination is made. In order to avoid a retroactive impact on the treatment of loss reserves on account of interest rates in years before the effective date, the base period does not include any calendar month beginning before January 1, 1987.

For example, the rate to be used in computing the discount factors for 1995, is 75 percent of the average of the annual Federal mid-term rates in effect at the beginning of each of the 60 calendar months during 1990-1994. On the other hand, the rate to be used in computing discount factors for 1989 is the average of such applicable rates for the 24-month period ending before January 1, 1989.

Once an interest rate assumption is established with respect to unpaid losses attributable to an accident year, the rate is not subsequently adjusted to reflect changes in the average Federal mid-term rate in later periods. Thus, the interest rate attributable to an accident year is vintaged with respect to that year.

Loss payment pattern.—The bill requires the Secretary of the Treasury to determine a loss payment pattern with respect to each line of business reported on Schedules O and P for a determination year. This loss payment pattern will be determined by reference to the historical loss payment pattern applicable to the line of business and applies to accident years ending with (or within) the determination year and each of the four succeeding years.

The determination year means the calendar year 1987 and each 5th calendar year after 1987. Thus, the Secretary is directed to re-

determine and publish the loss payment patterns on an industry-wide basis every five years.

Determinations of loss payments patterns are to be made (1) by using the aggregate experience reported on the annual statements of insurance companies to which the discounting provisions apply, (2) on the basis of the most recent published aggregate data from the annual statements relating to loss payment patterns available on the first day of the determination year, (3) by assuming that all losses are paid in the middle of the years, and (4) under certain computational assumptions with respect to the period over which the losses are paid.

At present, the aggregate data derived from the annual statements provides information for the accident year plus 2 years with respect to Schedule 0 lines of business and the accident year plus 9 years with respect to the Schedule P lines of business. Under the bill, the Secretary is directed to make appropriate adjustments with respect to the duration of payment patterns for future accident years if annual statement data is available for longer periods (e.g., because the period for which reporting is required on the annual statement is changed).

At the current time, aggregate loss payment pattern data is annually published by A.M. Best & Co., summarizing industry payout patterns by line of business and accident year as reported on Schedules 0 and P of the most recently filed annual statements. The committee intends that, as long as the information is published in its present form and supplies information with respect to at least the same number of accident years as is supplied as of the date of committee action, the Secretary is to use the data available in Best's Aggregates and Averages. In the case of title insurance (see the description of special rules relating to title insurance below), the committee intends that such information published by the American Land Title Association is to be used which is comparable to the information published in Best's Aggregates and Averages. It is anticipated that the title insurance loss payment patterns based on this data will be at least as long in duration as the payment patterns for Schedule P lines of business.

Under this provision, loss payment patterns announced for the period 1987-1991 are to make use of the most recent published aggregate data available on January 1, 1987, which is the data for 1985. The factors announced during 1992-1996 are to use the data available on January 1, 1992, which is expected to be 1990 data.

Computational rules.—The computational assumptions prescribed by the bill provide that the loss payment pattern for any line of business is to be based on losses paid (1) during the accident year and the 3 years following the accident year or (2) in the case of any line of business reported in the schedule or schedules of the annual statement relating to auto liability, other liability, medical malpractice, workers' compensation, and multiple peril lines of business (Schedule P lines), during the accident year and the 10 years following the accident year.

In the case of a line of business for which the accident year plus the 3 years following the accident year is used (generally, Schedule 0 lines), the bill provides that losses paid after the first year following the accident year are treated as paid equally in the succeeding

2 years. In the case of any other line of business, losses paid after the close of the 10-year period after the accident year are generally treated as paid in such 10th year.

The bill provides a special rule for certain long-tail lines of business. If the special rule applies, (1) the 10-year period following the accident year may be extended (but not by more than 5 years) and (2) the amount of losses that otherwise would have been treated as paid in the 10th year following the accident year are treated as paid in such 10th year and each subsequent year in an amount equal to the lesser of (a) the amount of losses paid in the 9th year following the accident year, or (b) the remaining amount of unpaid losses. If, at the end of 5 years following such 10th year, there is a remaining balance of unpaid losses, such losses are treated as if paid at the end of such 5th year without regard to the rule in the preceding sentence.

The special rule to extend the assumed loss payment period for long-tail lines of business applies if the amount of losses that would be treated as paid (under the general rule) in the 10th year following the accident year exceeds the amount of losses treated as paid in the 9th year following the accident year.

As an example of this special rule for long-tail lines of business, assume the following loss payment pattern:

Year	Loss Payment Pattern (percent)
Accident Year	25
Accident Year + 1	10
Accident Year + 2	8
Accident Year + 3	8
Accident Year + 4	8
Accident Year + 5	7
Accident Year + 6	7
Accident Year + 7	5
Accident Year + 8	5
Accident Year + 9	5
Accident Year + 10	12

In this example, the amount of losses paid in the 9th year following the accident year are less than the amount of losses treated as paid in the 10th year following the accident year. Accordingly, the special rule applicable to long-tail lines of business applies. Under this special rule, the amount of losses paid in the 10th and later years after the accident year are treated as equalling the amount of losses paid in the 9th year after the accident year. Therefore, under the special rule, the loss payment period is extended for an additional 2 years, as follows:

Year	Special Rule Loss Payment Pattern (percent)
Accident Year	25
Accident Year + 1	10
Accident Year + 2	8
Accident Year + 3	8
Accident Year + 4	8
Accident Year + 5	7
Accident Year + 6	7
Accident Year + 7	5
Accident Year + 8	5
Accident Year + 9	5
Accident Year + 10	5
Accident Year + 11	5
Accident Year + 12	2

Special rule for international and reinsurance

Under the bill, for the international and reinsurance lines of business, the discounting provisions are implemented on the basis of composite discount factors derived by combining the payment patterns for all Schedule P lines. Although reinsurance and international lines of business may be reported on Schedule O as a short-tail line of business, the committee is concerned that treating these lines as Schedule O lines for purposes of calculating discounted loss reserve deductions will create a disproportionately favorable effect on reinsurance and international insurance attributable to long-tail lines of business. If such long-tail lines were accurately reflected, the current loss reserve deduction would be lower than if such reinsurance and international insurance is treated as part of a Schedule O line of business, with assumed loss payments over a much shorter period of time.

The bill authorizes the Secretary to issue regulations requiring a company to follow a loss payment pattern that differs from the normal treatment of reinsurance as a composite of all Schedule P lines of business. The committee anticipates, for example, that in the case of a company substantially all of the reinsurance business of which is the reinsurance of medical malpractice insurance, the Secretary is to require such reinsurer to use a loss payment pattern that is an aggregate of all industry experience with respect to medical malpractice, rather than an aggregate of all industry experience for all Schedule P lines of business.

Special rules for accident and health insurance coverage

Under the bill, the active life reserves held for life insurance and noncancellable accident and health benefits (to the extent subject under present law to the life insurance company reserve rules (sec. 807(d)) are not subject to discounting under the new discounted unpaid

loss provisions (sec. 846). Rather, in the case of a property and casualty insurance company subject to the life insurance reserve rules with respect to a particular line of business, the amount of discounted unpaid losses for that line of business is the amount required under the life insurance reserve rules.

In addition, under the bill, in the case of unpaid losses relating to disability insurance (other than credit disability insurance), the general rules prescribed for the treatment of noncancellable accident and health insurance contracts under the life insurance company reserve provisions (sec. 807(d)) are to apply adjusted in the following manner: (1) the taxpayer may use its own experience relating to mortality and morbidity, (2) the prevailing State assumed interest rate to be used is the rate in effect for the year in which the loss occurred rather than the year in which the contract was issued, and (3) the rule limiting the amount of discounted losses to no more than the aggregate amount of unpaid losses as reflected on the annual statement applies. Similar treatment applies to noncancellable accident and health insurance provided by a life or by a property and casualty insurance company.

In the case of life insurance companies and property and casualty companies with respect to the types of accident and health insurance coverage (other than disability insurance) that are not currently subject to the life insurance company reserve requirements (such as cancellable accident and health coverage), such coverage is subject to the discounting provisions for property and casualty companies. It is assumed, for purposes of applying such provisions, that unpaid losses at the end of an accident year are paid in the year following the accident year. The type of insurance to which this rule applies primarily is medical reimbursement coverage.

Further, one type of accident and health insurance (credit disability) is more in the nature of a property and casualty type of line of business and, under the bill, is treated as a Schedule O line of business. While the committee did not consider it appropriate to treat credit disability in the same manner as life insurance, it concluded that treatment in the same manner as medical reimbursement would not reflect the typical loss payment pattern of such disability coverage. Therefore, credit disability is discounted over the same period as Schedule 0 lines of business.

Election by company to use its own experience

Under the bill, a taxpayer may elect to apply the general loss discounting rules by reference to the taxpayer's own historical loss payment pattern as of the end of a taxable year (the determination year). The taxpayer, if the election is made, is to use the taxpayer's most recent experience as reported on its annual statement. For each of the 5 years in the determination period, the taxpayer's most recent experience is to be used. Once a determination has been made by a taxpayer with respect to an accident year and line of business, the taxpayer may not redetermine its loss payment pattern to adjust for more recent information. This treatment is consistent with the general vintaging approach used for determining loss payment patterns on the aggregate experience for the industry.

The election by a taxpayer to use its own experience, once made, applies to all accident years and all lines of business of the taxpayer (except international and reinsurance lines, for which no election is permitted), and may not be revoked without the consent of the Secretary. The election may be made with respect to any determination year and applies for that determination year and the 4 succeeding calendar years. As under the general rules, the determination year is calendar year 1987 and each 5th succeeding calendar year after 1987.

The committee intends that the Secretary will permit companies to derive their loss payment patterns based on the information reported on the annual statement. To determine the assumed loss payment pattern for each "vintage" (i.e., accident year for a line of business), the following method may be used. The amount of losses deemed to be paid for the vintage in the current taxable year with respect to any vintage is the total paid losses for the vintage for the taxable year, divided by the total of paid and unpaid losses for the vintage in that taxable year, minus the same calculation for the subsequent vintage done for the taxable year.

For example, if a company's annual statement for 1985 shows that, for a line of business with an accident year of 1980 with total incurred losses of $100, $65 dollars are paid losses and $35 are unpaid losses. With respect to accident year 1981, for total incurred losses of $180, $60 dollars have been paid and $120 are unpaid losses. To determine the loss payment pattern for that line of business for the accident year plus 5 (i.e., 1980 is the accident year and 1985 is the accident year plus 5), the percentage of losses deemed paid in the accident year plus 5 (65 divided by 100 or 65 percent) is reduced by the percentage of losses deemed paid in the accident year plus 4 (60 divided by 180 or 33-1/3 percent). Therefore, the percentage of incurred losses deemed paid in the accident year plus 5 is 65 percent minus 33-1/3 percent or 21-2/3 percent.

Special rule for title insurance

Under the bill, the treatment of unearned premiums of title insurance companies is clarified for purposes of the partial disallowance of a deduction for unearned premiums and the discounting of unpaid losses. Thus, section 832(b)(4) does not apply to amounts denominated as unearned premiums by a title insurance company (including amounts characterized under State law as unearned premium reserves). Rather, such reserves are to be treated as reserves for unpaid losses under the contract subject to the new discounting rules. To the extent that the amount of such reserves is in excess of the unpaid loss reserves necessary for the protection of policyholders, it is not treated as a reserve amount.

Effective Dates

Under the bill, the provisions relating to the treatment of loss reserve deductions for property and casualty companies apply to taxable years beginning after December 31, 1986.

Under the bill, a transitional rule is provided with respect to the unpaid losses on outstanding business before the effective date of the provision. Under this transitional rule, for purposes of calculat-

ing a company's change in unpaid losses with respect to outstanding business, the unpaid losses at the end of the last taxable year beginning before January 1, 1987, and the unpaid losses as of the beginning of the first taxable year beginning after December 31, 1986, are determined as if the discounting provisions had applied to the unpaid losses (and unpaid expenses) in the last taxable year beginning before January 1, 1987. In addition, the interest rate and loss payment pattern assumptions with respect to such outstanding business is to be computed by using the rate and loss payment pattern applicable to accident years ending in 1987.

Further, the bill provides a fresh start with respect to undiscounted loss reserves applicable to the last taxable year beginning before January 1, 1987. Under this fresh start rule, the difference between the amount of undiscounted unpaid loss reserves and unpaid expenses (the recomputed reserves) at the end of the last taxable year beginning before January 1, 1987, and the amount of the discounted balances determined under the transitional rule, are not taken into account for purposes of determining the taxable income of an insurance company after the effective date.

Such fresh start adjustment is to be taken into account in full in the first taxable year to which the discounting provisions apply (i.e., the first taxable year beginning after December 31, 1986), for purposes of calculating any adjustment to earnings and profits. Any reserve strengthening after March 1, 1986, is to be treated as reserve strengthening for the first taxable year beginning after December 31, 1986. The committee intends that any adjustments to reserves that are attributable to changes in reserves on account of changes in the basis for computing reserves (i.e., reserve strengthening or reserve weakening) in a taxable year beginning before January 1, 1987, are not taken into account in determining taxable income after the effective date.

3. Protection Against Loss Account for Mutual Companies (sec. 1023 of the bill and sec. 824 of the Code)

Present Law

Mutual property and casualty insurance companies are permitted a deduction for contributions (which are bookkeeping entries) to a protection against loss ("PAL") account (sec. 824). The amount of the deduction is equal to the sum of 1 percent of the underwriting losses for the year plus 25 percent of statutory underwriting income, plus certain windstorm and other losses. In general, contributions to the PAL account are taken into income after a 5-year period. The PAL account thus effects a 5-year deferral of a portion of mutual company underwriting income.

Reasons for Change

The intent of Congress in enacting the PAL provision was to provide mutual companies with a source of capital to enable them to compete with stock companies, in the event of a catastrophic loss. While stock companies may enter capital markets and issue new stock to raise money in the event of a catastrophic loss, a mutual company, because it does not issue stock, may not do so. The 5-year

partial income deferral provides a source of capital not available to stock companies.

The committee believes that the deduction for contributions to the PAL account is not serving its intended purpose and therefore should be repealed. The PAL rules do not require that any funded account actually be maintained to protect against losses; rather, the only protection is afforded in the form of tax savings. The utility of the PAL is greatest where least needed, in the case of mutual companies with current taxable income that can benefit from deferral. Further, the comparison to the ability of stock companies with catastrophic losses to raise funds in capital markets may not be entirely appropriate, because any company may not readily be able to raise funds when its financial prospects are dimmed by serious losses. Therefore, the committee has taken action to repeal the provision.

Explanation of Provision

Code section 824, allowing a deduction for contributions to a PAL account, is repealed. PAL account balances are includible in income over the first five taxable years beginning after December 31, 1985. The amount includible is the greater of the amount includible for the year had the subtraction provisions of section 824 remained in effect (but no further additions had been made), or an amount equal to a required percentage of the balance remaining in the account at the close of the preceding taxable year. For taxable years beginning in 1987, the required percentage is 20; for 1988, 25; for 1989, 33-1/3; for 1990, 50; and for 1991, 100.

Effective Date

The repeal of the deduction for contributions to a PAL account is effective for taxable years beginning after December 31, 1986.

4. Special Exemptions, Rates, and Deductions of Small Mutual Companies (sec. 1024 of the bill and secs. 501, 821, 823 and 847 of the Code)

Present Law

Under present law, mutual property and casualty companies are classified into three categories depending upon the amounts of the gross receipts. Mutual companies with certain gross receipts not in excess of $150,000 are tax-exempt (sec. 501(c)(15)). Companies whose gross receipts exceed $150,000 but do not exceed $500,000 are "small mutuals" and generally are taxed solely on investment income. This provision does not apply to any mutual company that has a balance in its PAL account, or that, pursuant to a special election, chooses to be taxed on both its underwriting and investment income. Additionally, small mutuals which are subject to tax because their gross receipts exceed $150,000 may claim the benefit of a special rule which phases in the regular tax on investment income as gross receipts increase from $150,000 to $250,000. Companies whose gross receipts exceed $500,000 are ordinary mutuals taxed on both investment and underwriting income. Mutual recip-

rocal underwriters or interinsurers are generally taxed as mutual insurance companies, subject to special rules (sec. 826).

Like stock companies, ordinary mutuals generally are subject to the regular corporate income tax rates. Mutuals whose taxable income does not exceed $12,000 pay tax at a lower rate. No tax is imposed on the first $6,000 of taxable income, and a tax of 30 percent is imposed on the next $6,000 of taxable income. For small mutual companies which are taxable on investment income, no tax is imposed on the first $3,000 of taxable investment income, and a tax of 30 percent is imposed on taxable investment income between $3,000 and $6,000.

Mutual companies that receive a gross amount from premiums and certain investment income of less than $1,100,000 are allowed a special deduction against their underwriting income (if it is subject to tax). The maximum amount of the deduction is $6,000, and the deduction phases out as the gross amount increases from $500,000 to $1,100,000.

Reasons for Change

The present law applicable to small and certain ordinary mutual companies is inordinately complex and should be simplified. The committee believes that one provision should afford benefits comparable to present law to small mutual companies. Further, the committee believes it is appropriate to eliminate the distinction between small mutual companies and other small companies, and extends the benefit of the small company provision to all eligible small companies, whether stock or mutual.

Explanation of Provision

The bill provides that mutual and stock property and casualty companies are eligible for exemption from tax if their net written premiums or direct written premiums (whichever is greater) do not exceed $350,000. This provision changes the nature of the ceiling amount for tax exemption from certain gross receipts to direct or net written premiums, and increases the ceiling amount from $150,000 to $350,000.

In addition, the bill repeals the special rates, deductions and exempticns for small mutual companies and substitutes a single provision (sec. 847 of the Code). The new provision allows mutual and stock companies with net written premiums or direct written premiums (whichever is greater) in excess of $350,000 but less than $1,200,000 to elect to be taxed only on taxable investment income. To determine the amount of direct or net written premiums of a member of a controlled group of corporations, the direct or net written premiums of all members of the controlled group are aggregated.

Effective Date

The provisions are effective for taxable years beginning after December 31, 1986.

Revenue Effect of Part C

The provisions of Part C (items 1, 2, 3 and 4, above) are estimated to increase fiscal year budget receipts by $668 million in 1987, $1,290 million in 1988, $1,323 million in 1989, $1,361 million in 1990, and $1,324 million in 1991.

TITLE XI—MINIMUM TAX PROVISIONS

Minimum Tax on Corporations and Individuals (Title XI of the bill and secs. 53 and 55-59 of the Code)

Present Law

Corporate minimum tax

Under present law, corporations pay a minimum tax on certain tax preferences. The tax is in addition to the corporation's regular tax. The amount of the minimum tax is 15 percent of the corporation's tax preferences, to the extent that the aggregate amount of these preferences exceeds the greater of the regular income tax paid or $10,000 (Code sec. 56).

Tax preference items

The tax preference items included in the base for the minimum tax for corporations are:

(1) For real property, the excess of accelerated over straight-line depreciation, applying the useful life or recovery period prescribed for regular tax purposes (in the case of property eligible for ACRS, 19 years);

(2) For certified pollution control facilities, the excess of 60-month amortization over the amount of depreciation otherwise allowable;

(3) In the case of certain financial institutions, the excess of the bad debt deductions over the amount of those deductions computed on the basis of actual experience;

(4) Percentage depletion to the extent in excess of the adjusted basis of the property; and

(5) 18/46 of the corporation's net capital gain.

For personal holding companies, accelerated depreciation on leased personal property, mining exploration and development costs, circulation expenditures, research and experimental expenditures, and excess intangible drilling costs also give rise to preferences.

When a corporation has a regular tax net operating loss attributable to minimum tax preference items in excess of $10,000, no immediate add-on minimum tax liability is incurred with respect to those preference items. Minimum tax liability is incurred with respect to those preference items when the "preferential" portion of the net operating loss is used to offset regular taxable income, treating this portion as used only after nonpreferential net operating losses have been exhausted.

Cutback in certain preferences

In addition to imposing an add-on minimum tax, present law (sec. 291) imposes a cutback in the use of certain corporate tax pref-

erences for regular tax purposes. Adjustments are made to the corporate minimum tax to limit the reduction of the tax benefit from a preference. The cutback applies, with differing percentage reductions, to the following items: (1) certain excess depletion for coal and iron ore; (2) the portion of bad debt reserves deducted by financial institutions that exceeds deductions allowable under the experience method; (3) certain interest deductions of financial institutions that are allocable to purchasing or holding certain tax-exempt obligations; (4) a foreign sales corporation's (FSC) exempt foreign trade income; (5) the reduction of recapture, under section 1250, for depreciation deductions relating to real estate; (6) for pollution control facilities, the excess of the amortization deductions allowed over the depreciation deductions that would otherwise apply; (7) intangible drilling cost deductions of integrated oil companies; and (8) expensing of mineralexploration and development costs.

Individual minimum tax

Under present law, individuals are subject to an alternative minimum tax which is payable, in addition to all other tax liabilities, to the extent that it exceeds the individual's regular tax owed.[1] The tax is imposed at a flat rate of 20 percent on alternative minimum taxable income in excess of the exemption amount. However, the amount so determined is reduced by the foreign tax credit and any refundable credits.

Alternative minimum taxable income is generally equal to regular tax adjusted gross income, as increased by certain tax preferences and decreased by the alternative tax itemized deductions. The exemption amount, which is subtracted from alternative minimum taxable income before applying the 20 percent rate, is $40,000 for joint returns, $20,000 for married individuals filing separately, and $30,000 for single returns.

Tax preference items

The tax preference items that are added to the adjusted gross income basis for purposes of the alternative minimum tax on individuals are:

(1) Dividends excluded from gross income under section 116, which permits individuals to exclude dividends received in an amount not to exceed $100 ($200 for a joint return);

(2) For real property, the excess of accelerated over straight-line depreciation, applying the useful life or recovery period prescribed for regular tax purposes (in the case of property eligible for ACRS, 19 years);

(3) For leased personal property, the excess of accelerated depreciation over depreciation calculated under the straight-line method, with the latter being determined, in the case of property eligible for ACRS, by applying useful lives or recovery periods of five years for three-year property, eight years for five-year property, 15 years

[1] A taxpayer's regular tax means the taxes imposed by chapter 1 of the Code (other than the alternative minimum tax, the investment credit recapture tax (sec. 47), the taxes applicable in some instances for annuities (sec. 72(m)(5)(B) and 72(q)), lump sum distributions from qualified pension plans (sec. 402(e)), individual retirement accounts (sec. 408(f)), and certain trust distributions (sec. 667(b)), reduced by all nonrefundable credits including the foreign tax credit.

for 10-year property, and 22 years for 15-year public utility property;

(4) For certified pollution control facilities, the excess of 60-month amortization over the amount of depreciation otherwise allowable;

(5) For mining exploration and development costs (other than those relating to an oil or gas well) that are expensed, the excess of the deduction claimed over that allowable if the costs had been capitalized and amortized ratably over a 10-year period;

(6) For circulation expenditures (relating to newspapers, magazines and other periodicals) that are expensed, the excess of the deduction claimed over that allowable if the amounts had been capitalized and amortized ratably over a three-year period;

(7) For research and experimentation expenditures that are expensed, the excess of the deduction claimed over that allowable if the amounts had been capitalized and amortized ratably over a 10-year period;

(8) Percentage depletion to the extent in excess of the adjusted basis of the property;

(9) For net capital gains, the portion (i.e., 60 percent) deducted from gross income under section 1202, except that gain from the sale or exchange of the taxpayer's principal residence is not taken into account;

(10) For incentive stock options, the excess of the fair market value received through the exercise of an option over the exercise price; and

(11) For intangible drilling costs (relating to oil, gas, and geothermal properties) that are expensed, the amount by which the excess portion of the deduction (i.e., the excess of the deduction claimed over that allowable if the costs had been capitalized and amortized ratably over a 10-year period) exceeds the amount of net oil and gas income.

For certain of these preferences, individuals can elect for regular tax purposes to take a deduction ratably over 10 years (three years in the case of circulation expenditures) and thereby to avoid treatment of the item subject to the election as a minimum tax preference. The preferences, in addition to circulation expenditures, with respect to which such an election can be made are research and experimental expenditures, intangible drilling and development costs, and mining exploration and development costs. In addition, the ACRS provisions themselves allow certain similar elections.[2] In general, a principal reason for making such an election is to preserve for later years the value of an otherwise preferential deduction which would not benefit the taxpayer in the year when the election is made, because the taxpayer would be subject to the alternative minimum tax.

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[2] Moreover, in the case of intangible drilling costs, a taxpayer (other than a limited partner or a passive subchapter S shareholder) may elect to forego the expense deduction and claim five-year ACRS and the investment tax credit instead. A taxpayer making this election would not be subject to the minimum tax on these items.

Alternative tax itemized deductions

Certain of the itemized deductions allowable in calculating regular taxable income are allowable as well for purposes of calculating alternative minimum taxable income. The alternative tax itemized deductions are:

(1) Casualty or theft losses, and gambling losses to the extent not in excess of gambling gains;

(2) Charitable deductions, to the extent allowable for regular tax purposes;

(3) Medical deductions, to the extent in excess of 10 percent of adjusted gross income;

(4) Qualified interest expenses, which are limited to (a) qualified housing interest (i.e., interest incurred to acquire, construct, or rehabilitate a primary residence or other qualified dwelling used by the taxpayer), plus (b) other interest expenses deducted by the taxpayer, but only to the extent not in excess of qualified net investment income for the year;[3] and

(5) Deductions for estate tax attributable to income in respect of a decedent.

Other regular tax itemized deductions, such as those for State and local taxes, are not allowed for minimum tax purposes.

Tax credits and NOLs

In calculating minimum tax liability, no nonrefundable credits are allowed except for the foreign tax credit. The limitation on the foreign tax credit applying for regular tax purposes (which, in general, prevents use of the credit to offset a greater percentage of one's tax liability than the percentage of taxable income that is foreign source income) applies for minimum tax purposes as well, but is recalculated to reflect the percentage of minimum taxable income that comes from foreign sources. Credits that do not benefit the taxpayer because of the imposition of minimum tax liability can be carried back or forward to other taxable years.

Individuals with net operating losses are allowed to deduct such losses against alternative minimum taxable income. However, for years beginning after 1982 the losses are computed, for minimum tax purposes, by reducing the regular tax net operating losses by the amount of the items of tax preference.

Reasons for Change

The committee believes that the minimum tax should serve one overriding objective: to ensure that no taxpayer with substantial economic income can avoid significant tax liability by using exclusions, deductions, and credits. Although these provisions may provide incentives for worthy goals, they become counterproductive when taxpayers are allowed to use them to avoid virtually all tax liability. The ability of high-income individuals and highly profitable corporations to pay little or no tax undermines respect for the

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[3] Since this limitation applies only to itemized deductions for interest expenses, it generally has no effect on interest deductions that are claimed "above-the-line," such as business interest and interest attributable to the production of rents and royalties. Interest to carry limited partnership interests and S corporation stock is treated as an itemized deduction, however.

entire tax system and, thus, for the incentive provisions themselves. In addition, even aside from public perceptions, the committee believes that it is inherently unfair for high-income individuals and highly profitable corporations to pay little or no tax due to their ability to utilize various tax preferences.

In particular, both the perception and the reality of fairness have been harmed by instances in which major companies have paid no taxes in years when they reported substantial earnings, and may even have paid substantial dividends to shareholders. Even to the extent that these instances reflect deferral, rather than permanent avoidance, of corporate tax liability, the committee believes that they demonstrate a need for change.

The committee believes that the minimum taxes under present law do not adequately address the problem of tax avoidance, principally for two reasons. First, the corporate minimum tax, as an add-on rather than an alternative tax, is not presently designed to define a comprehensive income base. Second, the present minimum taxes on both individuals and corporations do not sufficiently approach the measurement of economic income. By leaving out many important tax preferences, or defining preferences overly narrowly, the individual and corporate minimum taxes permit some taxpayers with substantial economic incomes to report little or no minimum taxable income and thus to avoid all tax liability.

With respect to certain items that constitute tax preferences, at least for some taxpayers, under present law, the committee believes that modifications of the definitions of the preferences are needed. In particular, in the case of accelerated depreciation on real and personal property, the committee believes that present law fails to account for the fact that the useful lives of items of real and personal property generally are longer than the useful lives applying for minimum tax purposes.

Moreover, the committee believes that certain items, not presently treated as preferences, must be added to the minimum tax base if the minimum tax is to serve its intended purpose of requiring taxpayers with substantial economic incomes to pay some tax. The items as to which the committee has reached this determination include use of the completed contract method of accounting, use of the installment method by dealers, and use of capital construction funds by shipping companies.

In order to prevent individuals with substantial economic incomes from avoiding liability through the use of tax shelters, the committee believes that the use of net losses relating to nonparticipatory business activities should be limited for minimum tax purposes, under rules similar to those applying under the bill for regular tax purposes. Both general minimum tax preference provisions and limitations on the use of nonparticipatory business losses are necessary to ensure that individuals with substantial incomes will pay some tax, whether they use preferences to offset tax on income from a single business activity, or use losses from one activity to offset income from another.

In the case of farming losses of individuals who do not materially participate in the farming business, the committee believes that an additional and stricter rule should apply for minimum tax purposes, preventing any loss with respect to a passive farming activi-

ty from offsetting other income of the taxpayer prior to disposition. The committee believes that such a rule is needed in the farming context, in addition to the rules generally applying to nonparticipatory business losses, in light of the harm to taxpayers active in the farming business that has resulted from the proliferation of tax shelter farming activities that exploit the competitive cost advantage of passive investors who can use tax losses derived from farming to offset unrelated income.

With respect to corporations, the committee believes that the goal of applying the minimum tax to all companies with substantial economic incomes cannot be accomplished solely by compiling a list of specific items to be treated as preferences. The minimum tax cannot successfully address concerns of both real and apparent fairness unless there is certainty that whenever a company publicly reports substantial earnings (either pursuant to public reporting requirements, or through voluntary disclosure for substantial nontax reasons), that company will pay some tax (unless it has sufficient net operating losses to offset its income for the year).

Thus, the committee believes that it is important to provide that the alternative minimum taxable income of a corporation will be increased when book income for the year exceeds alternative minimum taxable income. Such a provision will increase both the real and the perceived fairness of the tax system, eliminate the highly publicized instances in which corporations with substantial book income have paid no tax, and further broaden the minimum tax base to approach economic income more closely.[4]

A further change that the committee believes is necessary relates to the use of foreign tax credits by U.S. taxpayers to avoid all U.S. tax liability. Absent a special rule, a U.S. taxpayer with substantial economic income would be able to avoid all U.S. tax liability so long as all of its income was foreign source income and it paid foreign tax at the U.S. regular tax rate or above. While allowance of the foreign tax credit for minimum tax purposes generally is appropriate, the committee believes that taxpayers should not be permitted to use the credit to avoid *all* minimum tax liability. U.S. taxpayers generally derive benefits from the protection and applicability of U.S. law, and in some cases from services (such as defense) provided by the U.S. Government, even if all of such taxpayers' income is earned abroad. Thus, it is fair to require at least a nominal tax contribution from all U.S. taxpayers with substantial economic incomes.

With regard to the preference relating to the expensing of research and experimentation expenditures, however, the committee believes that, for incentive reasons, corporations, including person-

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[4] In the absence of tax preferences, tax accounting generally requires a broader and more accelerated reporting of income than does financial accounting. For reasons of conservatism, financial accounting is designed to err on the side of understatement, rather than overstatement, of income. *Thor Power Tool Co.* v. *Commissioner*, 439 U.S. 522 (1979). *See also* Note, "The Tax Treatment of Research and Development Expenditures: A Comparison Between Financial Accounting Standards and Section 174 of the Internal Revenue Code," 10 *Rutgers Computer & Technology L.J.* 149, 157-58 (1984), describing the "conservative tendencies" of the accounting profession with respect to "describing current profits and assets in any situation of uncertainty." In light of such conservatism, alternative minimum taxable income generally should not be lower than book income for any substantial period of time, absent tax preferences that have not been separately identified.

al holding companies, should not be required to treat such expensing as a preference. At the same time, the committee believes that such expensing should continue to be treated as a preference for individuals, because of the use of such expensing in tax shelters marketed to individuals. The committee believes that the preference for mining exploration and development expenditures should continue, as under present law, to apply only to individuals and personal holding companies, in light of hardships presently being experienced by the mining industry.

Finally, the committee believes that the present law structure of the alternative minimum tax requires modification in certain respects. In particular, to the extent that tax preferences reflect deferral, rather than permanent avoidance, of tax liability, some adjustment is required with respect to years after the taxpayer has been required to treat an item as a minimum tax preference, and potentially to incur minimum tax liability with respect to the item. Absent such an adjustment, taxpayers could lose the benefit of certain deductions altogether.

Explanation of Provisions

1. Overview

The bill repeals the present law add-on minimum tax for corporations beginning in 1987, creates a new alternative minimum tax on corporations, and expands the alternative minimum tax on individuals.

Corporations.—Generally, the tax base for the alternative minimum tax on corporations is the taxpayer's regular taxable income, increased by the taxpayer's tax preferences for the year and adjusted by computing certain deductions in a special manner which negates the acceleration of such deductions under the regular tax. The resulting amount, called alternative minimum taxable income, then is reduced by an exemption amount and is subject to tax at a 20-percent rate. The amount so determined may then be offset by the minimum tax foreign tax credit to determine a "tentative minimum tax." These rules are designed to ensure that, in each taxable year, the taxpayer must pay tax equalling at least 20 percent of an amount more nearly approximating its economic income (above the exemption amount). The exemption amount for corporations is $40,000, reduced (but not below zero) by 25 percent of the amount by which alternative minimum taxable income exceeds $150,000.

The net minimum tax, or amount of minimum tax due, is the amount by which the tax computed under this system (the tentative minimum tax) exceeds the taxpayer's regular tax. Although the minimum tax is, in effect, a true alternative tax, in the sense that it is paid only when it exceeds the regular tax, technically the taxpayer's regular tax continues to be imposed, and the net minimum tax is added on.

Individuals.—The structure for the alternative minimum tax on individuals generally is the same as under present law, except that adjustments are permitted in order to reflect the fact that certain deferral preferences (such as accelerated depreciation) cannot be treated simply as add-ons if total income is to be computed properly over time. For such preferences, the minimum tax deduction

may in some instances exceed the regular tax deduction (e.g., in the later years of an asset's life), thus insuring that basis will be fully recovered under both the regular and the minimum tax systems. The alternative minimum tax on individuals differs from that applying to corporations in several respects. For example, there are some differences between the preferences applying to individuals and those applying to corporations, and certain itemized deductions that individuals can claim for regular tax purposes are not allowable under the minimum tax. While the exemption amounts for individuals under present law generally are retained, they are reduced (but not below zero) by 25 percent of the amount by which alternative minimum taxable income exceeds $150,000. For married taxpayers filing separately and for trusts, the phaseout begins at $75,000; for single taxpayers the phaseout begins at $112,500.

Minimum tax credit.—When a taxpayer pays alternative minimum tax, the amount of such tax paid (i.e., the net minimum tax) is allowed as a credit against the regular tax liability of the taxpayer in subsequent years. However, this credit (known as the minimum tax credit) cannot be used to reduce tax below the tentative minimum tax in subsequent years. The minimum tax credit applies only to minimum tax liability incurred due to deferral preferences (such as accelerated depreciation), i.e., preferences for which the timing, rather than the amount, of a deduction gives rise to its treatment as a tax preference.

Normative elections.—Taxpayers generally may elect to have the minimum tax treatment of certain expenditures apply for regular tax purposes. When an election is made, no preference is added or treated as an adjustment for minimum tax purposes.

Incentive credits.—Nonrefundable credits (such as the general business credit) cannot be used to reduce regular tax liability to less than the tentative minimum tax. Credits that cannot be used by the taxpayer due to the effect of the alternative minimum tax can be carried over to other taxable years under the rules generally applying to credit carryovers.

2. Preferences and adjustments applying to both individuals and corporations

Depreciation

Accelerated depreciation (ACRS) on real and personal property placed in service after 1986, to the extent in excess of depreciation calculated under an alternative method, is treated as a preference.[5] The amount of the preference is calculated, with respect to such new property, by making adjustments similar to the types of adjustments that are made in determining the depreciation allowable with respect to earnings and profits. That is, instead of making preference adjustments with respect to specific items of property in the amount by which the ACRS deduction exceeds the alternative deduction, the alternative depreciation deduction is substituted for the ACRS deduction for all property placed in service after 1986. The principal effect of this system is that it permits

[5] The preference does not apply, however, to property that is expensed under section 179.

"netting", i.e. to the extent that, for a particular year, an alternative deduction relating to an item of property exceeds the ACRS deduction for that year, the amount of the preference is reduced.[6]

Consider, as an example that does not reflect the actual details of the ACRS and alternative depreciation systems, the case of a taxpayer who was permitted to deduct fully a $10 expense in the year that the property to which the expense related was placed in service, but who was required to write off the expense over two years for purposes of the alternative depreciation system. For that taxpayer, assuming there were no other differences between the taxpayer's regular and minimum taxable income, regular taxable income would be $5 less than minimum taxable income for the year in which the property was placed in service. In the following taxable year, however, the taxpayer's regular taxable income would be $5 greater than minimum taxable income (because no further ACRS deduction would remain with respect to the property, whereas the taxpayer would still be entitled to write off the last $5 of basis under the alternative system). If the taxpayer also had a separate preference in the amount of $5 in the second year, the taxpayer's regular and minimum taxable incomes would be equivalent in that year (whether or not that second item related to depreciation).

Regular tax depreciation with respect to property placed in service prior to 1987 is treated as a preference only to the extent that it constitutes a preference under present law. Thus, for example, for pre-1987 personal property, regular tax depreciation is a corporate tax preference only in the case of leased personal property in the hands of a personal holding company. In addition, present law rules apply to the measurement of depreciation preferences relating to pre-1987 property. Thus, for example, present law rules for measuring the amount of depreciation that constitutes a preference continue to apply to pre-1987 property, and preferences relating to such property continue to be measured on an item-by-item basis, rather than under the netting system described above.

For property placed in service after 1986, alternative depreciation generally is defined as straight-line depreciation over the ADR midpoint life of the property (forty years in the case of real estate). A similar depreciation system presently is used and will continue to be used with respect to property leased by a taxable entity to a tax-exempt entity. Under the bill, the alternative depreciation system applies for certain other purposes as well (including the measurement of depreciation for determining earnings and profits and with respect to property placed in service outside of the United States). Since taxpayers can elect to use this depreciation system for regular tax purposes, no minimum tax adjustment to income is made to the extent that any such election applies. (A complete description of the alternative depreciation system is described in the portion of the report describing the bill's provisions in the area of depreciation.)

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[6] Alternative deductions exceed ACRS deductions in the later years of the useful life of an item of property for which ACRS is allowed; i.e., at such time the ACRS deduction is understated because it has been overstated in prior taxable years.

As an exception to the general rule treating ACRS on post-1986 property as a preference, no adjustment is made for minimum tax purposes with respect to certain property described in paragraph (1), (2), (3), or (4) of section 168(f) (e.g., generally property depreciated under the income forecast method, etc.).[7] Property placed in service after 1986 that qualifies for a transitional exception to section 201 of the bill is excepted from the bill's minimum tax provisions for post-1986 property as well.

For all depreciable property to which minimum tax adjustments apply, adjusted basis is determined for minimum tax purposes with reference to the amount of depreciation allowed for minimum tax purposes under the alternative system. Thus, the amount of gain on the disposition of such property will differ for regular and minimum tax purposes.

Amortization of certified pollution control facilities

As under present law, rapid amortization of a certified pollution control facility is treated as a preference. For such facilities placed in service after 1986, the preference is treated under a rule similar to that for post-1986 depreciable property generally, i.e., the taxpayer is required to use the alternative recovery system for minimum tax purposes.

Use of completed contract method of accounting

In the case of any long-term contract entered into by the taxpayer after March 1, 1986, use of the completed contract method of accounting, or certain other methods of accounting for long-term contracts, is not permitted for purposes of the minimum tax. Instead, the taxpayer is required to apply the percentage of completion method in determining minimum taxable income relating to that contract. As with depreciation and mining exploration and development costs, this preference is calculated, not by adding an amount to regular taxable income, but by substituting the minimum tax treatment for the regular tax treatment with respect to all items arising with respect to a contract to which the preference relates.

Percentage depletion

As under present law, the excess of the regular tax deduction allowable for depletion over the adjusted basis of the property at the end of the taxable year (determined without regard to the depletion deduction for the taxable year) is treated as a preference. Thus, for example, a taxpayer who claimed a deduction for percentage depletion in the amount of $50, with respect to property having a basis (disregarding this deduction) of $10, would have a minimum tax preference in the amount of $40.

Intangible drilling costs

The preference for intangible drilling costs is the same as the present law preference for individuals, except that it is extended to

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[7] With respect to public utility property, taxpayers are required to use a normalization method of accounting in order to depreciate such property under the alternative system. The Secretary shall prescribe the requirements of a normalization method of accounting in this context.

apply to all corporations. Thus, the amount of excess intangible drilling costs is treated as a preference only to the extent that it exceeds the taxpayer's net income for the taxable year from oil, gas, and geothermal properties. Net oil and gas income is determined without regard to deductions for excess intangible drilling costs. Under this rule, for example, a taxpayer with $100 of net oil and gas income (disregarding excess intangible drilling costs) and $120 of excess intangible drilling costs would be required to treat such costs as a preference in the amount of $20 ($120 excess IDC less $100 net income offset).

The amount of excess intangible drilling costs is defined as the amount of the excess, if any, of the taxpayer's regular tax deduction for such costs (deductible under either section 263 or 291) over the normative deduction, i.e., the amount that would have been allowable if the taxpayer had amortized the costs over 120 months on a straight-line basis or had recovered the costs through cost depletion. The preference does not apply to costs incurred with respect to a nonproductive well.

In applying the preference for intangible drilling costs, a taxpayer's property (as under present law for individuals) is divided into two parts: properties that are geothermal deposits, and all other properties with respect to which intangible drilling costs are incurred. This separation applies for all purposes under the minimum tax. Consider, for example, the case of a taxpayer who has (1) oil wells with net oil and gas income of $100 and excess intangible drilling costs of $120, and (2) geothermal deposits with net income of $100 and excess intangible drilling costs of $80. This taxpayer has a preference in the amount of $20 with respect to the oil wells, and no preference with respect to the geothermal deposits.

With respect to intangible drilling costs for any well, the taxpayer may elect the use of any method which would be permitted for purposes of determining cost depletion with respect to such well. To be effective, such an election must be made at such time and in such manner as prescribed by the Secretary in regulations. Once made, such an election applies, with respect to the costs subject to it, for all regular and minimum tax purposes. Thus, costs recovered under this method are not treated as a minimum tax preference.

In the case of a disposition of any oil, gas, or geothermal property to which section 1254 generally would apply, or of any mining property to which section 617(d) generally would apply, if the taxpayer makes an election as described above (or to the extent of a normative election, as described below), amounts deducted pursuant to the election are treated as deducted for purposes of section 1254 or section 617(d), as the case may be.

Installment sales of dealer property

In the case of a disposition of dealer property after March 1, 1986, the installment method of accounting does not apply for minimum tax purposes. Thus, the taxpayer is required, for minimum tax purposes, to recognize all gain with respect to the disposition in

the year in which the disposition takes place.[8] The rule applies to dispositions of property defined in section 1221(1), i.e., stock in trade, other property of a kind properly included in inventory if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business.[9]

3. Additional preferences (other than limitations on itemized deductions) applying to individuals

Mining exploration and development costs

Mining exploration and development costs, incurred after 1986, that are expensed (or amortized under section 291) for regular tax purposes are required to be recovered through ten-year straight line amortization for purposes of the alternative minimum tax. As with depreciation, the minimum tax treatment of mining exploration and development costs involves a separate calculation for all items of income and expense relating to such costs. Thus, for example, in the case of a noncorporate taxpayer who incurred a one-time mining exploration and development expense in the amount of $100, the regular tax deduction would be $100 in the year when the expenditure was incurred, and the minimum tax deduction would be $10 for each of the ten years beginning in the year when the expenditure was incurred. The basis of property with respect to which such costs were incurred, and the amount of gain or loss upon disposition, likewise may differ for regular and minimum tax purposes, respectively.

Under this approach, when a loss is sustained with respect to a mining property (e.g., the mine is abandoned as worthless, giving rise to a loss under section 165), the taxpayer is permitted to deduct, for minimum tax purposes, all mining exploration and development costs relating to that property that have been amortized and not yet written off under the minimum tax. The preference applies to personal holding companies as well as to individuals.

Circulation expenditures

An individual who incurs circulation expenditures described in section 173 is not permitted to expense his post-1986 expenditures for minimum tax purposes. Instead, in computing alternative minimum taxable income, the taxpayer is required to amortize such post-1986 expenditures ratably over a three-year period. However, if the taxpayer realizes a loss with respect to property to which any such expenditures relate, all such expenditures relating to that property but not yet deducted for minimum tax purposes are al-

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[8] In the case of a disposition occurring between March 1, 1986, and December 31, 1986 (in the case of a dealer who is a calendar year taxpayer), with respect to which the taxpayer elects the installment method for regular tax purposes, the result of this rule is that all gain is treated as recognized for minimum tax purposes in 1986. Since the alternative minimum tax as amended by the bill is not effective until 1987, the rule's sole effect on the tax treatment of such a disposition is that amounts relating to the disposition, included in regular taxable income in years after 1986 under the installment method, are not included in alternative minimum taxable income for such years.

[9] There is an exception to the rule, relating to certain timeshares and residential lots where an election is made to pay interest pursuant to section 453C. In addition, under a transitional exception, the preference does not apply to any disposition that qualifies for the exception described in section 311 of the bill.

lowed as a minimum tax deduction. The preference applies to personal holding companies as well as to individuals.

For example, an individual who incurred such expenditures in the amount of $30 would claim a regular tax deduction for the entire amount in the year when the expenditures were incurred, and would claim alternative minimum tax deductions of $10 for that year and the two succeeding taxable years. However, if the newspaper to which the expenditures related ceased operations in the second year, the entire $20 which was not allowed as a minimum tax deduction in the first year would be allowed for minimum tax purposes in the second year.

Research and experimental expenditures

An individual who incurs research and experimental expenditures described in section 174 is not permitted to expense the expenditures for minimum tax purposes. Instead, in computing alternative minimum taxable income, the taxpayer is required to amortize such post-1986 expenditures over a ten-year period. As with certain other items (such as depreciation and mining exploration and development costs), this treatment applies for all minimum tax purposes, rather than as an annual adjustment to regular taxable income. If the taxpayer abandons a specific project to which any such expenditures relate, all such expenditures relating to that property but not yet deducted for minimum tax purposes are allowed as a minimum tax deduction.

For example, an individual who incurred research and experimental expenditures in the amount of $100 would claim a regular tax deduction for the entire amount in the year when the expenditures were incurred (absent a section 174(b) election), and would claim alternative minimum tax deductions of $10 for that year and the nine succeeding taxable years. However, if the taxpayer abandoned the specific project to which the expenditures related in the second year, the entire $90 which was not allowed as a minimum tax deduction in the first year would be allowed for minimum tax purposes in the second year.

Incentive stock options

As under present law, in the case of a transfer of a share of stock pursuant to the exercise of an incentive stock option (as defined in section 422A), the amount by which the fair market value of the share at the time of the exercise exceeds the option price is treated as a preference. For purposes of this rule, the fair market value of a share is determined without regard to any restrictions other than one which, by its terms, will never lapse.

Passive farm losses

Any passive farm loss of an individual, to the extent not already denied for minimum tax purposes under the preferences described above, generally is treated as a preference. A passive farm loss is defined as the taxpayer's loss for the taxable year from any tax shelter farming activity. The amount of the preference is reduced, however, by the amount, if any, of the taxpayer's insolvency, as measured using a standard similar to that set forth in section 108(d)(3).

For purposes of this provision, the term "tax shelter farm activity" means (1) a farming syndicate (as defined in section 464(c), as modified by section 461(i)(4)(A)), and (2) any other activity consisting of farming unless the taxpayer materially participates in the activity. A taxpayer is treated as materially participating in the activity under the material participation standard set forth for regular tax purposes in section 469 (relating to passive losses), if a member of the taxpayer's family (within the meaning of section 2032A(e)(2)) so participates, or if the taxpayer meets the requirements of paragraph (4) or (5) of section 2032A(b) (relating to certain retired or disabled individuals and surviving spouses.)

Under the passive farm loss rule, deductions allocable to a tax shelter farming activity, to the extent in excess of gross income allocable to the activity, are disallowed, for minimum tax purposes. A separate activity is defined consistently with section 469, with the result that generally each farm is treated as a separate activity.

The rules for applying this preference generally are similar to those for applying the passive loss rule for minimum tax purposes (see below), except that there is no netting between different farming activities. An excess farm loss with respect to any farming activity is disallowed even if there is net income from other farming activities, and is carried forward until offset by income from the same activity or until there is an appropriate disposition. The amount of the deductions allocable to a farming activity is determined after taking account of all preferences and making all adjustments required for the determination of alternative minimum taxable income, other than the preference for excess passive losses generally. In other words, no deduction which is treated as a minimum tax preference, or which is redetermined (as with depreciation) for minimum tax purposes, is "double-counted" by also being considered in the determination of passive farm losses.

Passive activity losses

In computing alternative minimum taxable income, limitations apply to the use of losses from passive business activities to offset other income of the taxpayer. The rule is identical to that applying for regular tax purposes, under section 1401 of the bill, except for three differences. First, the rule is fully effective in 1987 for minimum tax purposes, whereas it is phased in over five years for regular tax purposes. Second, solely for minimum tax purposes, the amount of losses that otherwise would be disallowed for the current taxable year under the limitation is reduced by the amount, if any, of the taxpayer's insolvency, as measured using a standard similar to that set forth in section 108(d)(3). Third, in applying the limitations, minimum tax rules (including the passive farm loss rule) apply to the measurement and allowability of all relevant items of income, deduction, and credit.

The amount of any passive loss that is subject to disallowance is determined after computing all preferences and making all other adjustments to income that apply for minimum tax purposes (including the minimum tax interest limitation and the passive farm loss preference). Thus, the amount of suspended losses relating to

an activity may differ for minimum and regular tax purposes, respectively.

4. Additional preferences applying to corporations

Reserves for losses on bad debts of financial institutions

As under the present law add-on corporate minimum tax, certain excess reserves of a financial institution to which section 585 or 593 applies are treated as a minimum tax preference. The preference is defined as equal to the excess of the reserve for bad debts deducted by the taxpayer over the amount that would have been allowable had the taxpayer maintained its bad debt reserve for all taxable years on the basis of actual experience.

Capital construction funds of shipping companies

The use of a capital construction fund established under section 607 of the Merchant Marine Act of 1936 is treated as a minimum tax preference. Thus, amounts deposited in such a fund after 1986 are not deductible, and earnings (including gains and losses) of such a fund after 1986 are not excludable, in determining alternative minimum taxable income. In light of the preference, other adjustments required by the Merchant Marine Act of 1936 with respect to amounts withdrawn from a capital construction fund (e.g., reduction in basis under section 607(g)) of such Act) do not apply to the extent that such amounts have previously been included in alternative minimum taxable income. For this purpose, amounts deposited in or earned by a capital construction fund before 1987 are treated as withdrawn prior to amounts deposited or earned after 1986.

Effect of section 291

For purposes of the corporate minimum tax preferences, the amount of a preference is measured after the application of section 291. Thus, for example, to the extent that a taxpayer's bad debt reserve is reduced for regular tax purposes pursuant to section 291, the amount of such reduction is not "double-counted" by being treated as a minimum tax preference.

Business untaxed reported profits

In general

The committee bill provides that alternative minimum taxable income of a corporation includes one-half of the amount by which the adjusted net book income of the taxpayer exceeds the alternative minimum taxable income of the taxpayer before any amount is added to alternative minimum taxable income as a result of this preference. In general, the book income of a corporate taxpayer is the net income or loss set forth on the taxpayer's applicable financial statement. Certain adjustments are made to conform net income to reflect the activities of the corporations included in any consolidated tax return, to remove the effect of Federal and foreign income taxes, and for other purposes.

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Financial statement income

The starting point for the computation of the book income preference is the net income disclosed on the taxpayer's applicable financial statement. Net income is the amount the taxpayer reports that takes into account all items of revenue, expense, gain and loss attributable to the taxable year according to the taxpayer's normal method of accounting. Normally, this amount will be disclosed as part of an income statement prepared for inclusion in the taxpayer's applicable financial statement. The amount of net income should reconcile with the balance sheet of the corporation and be the same amount used in any computation of changes in owners' equity. Alternative measures of net income, such as a statement of sources and uses of funds or inflation-adjusted income statements, are not to be considered as determining net income unless the taxpayer determines its asset, liability, and owners' equity balances on its applicable financial statement in accordance with such an approach.[10]

The taxpayer's applicable financial statement generally is expected to include an income statement, a balance sheet stating the amount of assets, liabilities, and owners' equity, a statement of changes in owners' equity, and such other information as is determined to be appropriate for disclosure. An income statement by itself may constitute a taxpayer's applicable financial statement where the other materials generally expected to be included are not prepared or used by the taxpayer. However, an income statement that does not reconcile with financial statement materials otherwise issued generally will not be considered as establishing net income for the purpose of computing this preference.

The taxpayer's applicable financial statement is the statement it provides for regulatory or credit purposes, for the purpose of reporting to shareholders or other owners, or for other substantial nontax purposes. In the case of a corporation that has more than one financial statement, rules of priority are provided for the determination of which statement is to be considered as the applicable financial statement for the purpose of determining net book income.

The highest priority is given to financial statements that are required to be filed with the Securities and Exchange Commission. Second in priority are audited financial statements that are certified by a professional accountant and used for credit purposes, for reporting to shareholders or other owners, or for any other substantial nontax purpose. For this purpose, a financial statement is considered to be certified if it is accompanied by an opinion of a professional accountant stating that the financial statement generally is consistent with the taxpayer's accounting principles. Third in priority are financial statements required to be provided to the Federal Government or its agencies (other than the Securities and

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[10] Financial statement income generally will include the amount of any interest received by the taxpayer that otherwise is exempt from taxation (e.g., interest described in section 103). However, any such interest shall be considered to be exempt from tax for all other purposes under the Code, e.g., in applying (for both regular and minimum tax purposes) section 265(2), relating to deductions for interest on debt used to purchase or carry tax-exempt obligations, and section 291(a)(3), relating to interest deductions on debt used by a financial institution to purchase or carry tax-exempt obligations.

Exchange Commission), a State government or its agencies, or a political subdivision or its agencies. In the absence of any of the above, any financial statement or report that is used for credit purposes, for reporting to shareholders or other owners, or for any other substantial nontax purpose is considered the applicable financial statement. Within a category of priority, a financial statement used for credit purposes has the highest priority, followed by a financial statement provided to shareholders or other owners. A financial statement used for any other substantial nontax purpose has the lowest priority.

In applying these rules of priority, the financial statement actually must be used for reporting for credit purposes, to shareholders, or for a substantial nontax purpose. A financial statement that is not so used is not eligible to be considered as the applicable financial statement in the calculation of the book income preference amount. For example, an unregulated corporation may obtain a certified, audited financial statement, but report to creditors and shareholders using an alternative financial statement that is neither audited nor certified. In such an instance, the alternative, unaudited financial statement is the applicable financial statement and the net income stated in it is used in determining the amount of the preference.

The committee anticipates that all corporate taxpayers will have one or more of the above financial statements. Taxpayers generally are required to maintain books and records. Where the books and records of the taxpayer may be summarized to yield a financial statement, that summarization may be used as the applicable financial statement for the purpose of determining the preference amount. In the case where the taxpayer has no books or records that are capable of summarization, and thus has no applicable financial statement within the meaning of this provision, the net income or loss of the taxpayer for financial reporting purposes will be considered to be equal to the taxpayer's earnings and profits for the taxable year.

A taxpayer that does not file a financial statement with the Securities and Exchange Commission, a government or governmental agency or obtain a certified, audited financial statement may elect to use the earnings and profits for the taxable year in place of the net income disclosed on its applicable financial statement. A taxpayer making such an election is required to continue to use the earnings and profits calculation so long as it is eligible for the election.

In certain cases, adjustments may be made to reported financial statement income after the financial statements have been issued. It is not anticipated that such adjustments will be taken into account unless the financial statement is actually restated for the adjustments. In the case where a higher priority financial statement has been issued that is not adjusted, but a lower priority financial statement is adjusted, the higher priority, unadjusted financial statement will continue to be considered the applicable financial statement.

For example, a corporation obtains a certified, audited financial statement that it provides to its shareholders. Later, it is determined that the results of the corporation would be better reflected

by the use of an alternative accounting method as to certain items. A second income statement reflecting the alternative accounting method is prepared for credit purposes, but it is not certified by a professional accountant and the earlier certified statement is not recalled for correction. As the earlier certified statement has a higher priority than the later uncertified statement, the earlier statement will be considered the applicable financial statement and used in determining the preference amount. If the earlier statement had not been certified, the later statement would be the applicable financial statement, since the provision of a statement for credit purposes has priority over a statement issued to shareholders where both or neither are certified. If both statements had been of equal priority, the later statement would be considered the applicable financial statement.

A similar problem may arise where financial statements are not restated, but supplementary documents are provided to allow the user of the information to determine a different measure of income. If such is the case, the issuance of the supplementary documents will be considered to be the same as the issuance of a restated income statement.

Adjustments

In order to determine properly the amount by which net book income exceeds alternative minimum taxable income, certain adjustments are required to be made.

The book income preference item is determined with regard to the companies included in the taxpayer's consolidated group income tax return for the year.[11] To the extent that different companies may be included for financial statement purposes, it is necessary to adjust net book income so that it reflects the same companies that are included in the consolidated tax return. It is anticipated that this adjustment will be accomplished by removing the net income and any related consolidating eliminations of companies that are included for financial statement purposes but not for Federal income tax purposes, and by adding in the net income and related consolidating eliminations of companies that are excluded for financial statement purposes but included for Federal income tax purposes. In determining the consolidating eliminations of companies included for Federal income tax purposes but not for financial statement purposes, the method of consolidation that the taxpayer normally uses for financial statement purposes will be followed.

A taxpayer is required to record as an item of book net income the amount of any actual or deemed distribution (as measured for tax purposes) from another corporation if the other corporation is not included in the taxpayer's tax consolidated group for the year. If the taxpayer includes its ownership of the other corporation for financial purposes using another method, such as by consolidation or by the equity method, an adjustment to reverse the inclusion of the other corporation is required. If the corporation not included in the tax consolidation is consolidated in the applicable financial

[11] Thus, for example, it does not include foreign companies or section 936 corporations, which cannot be consolidated for tax purposes.

statement, its contribution to book net income is reversed as discussed above. If the corporation is not consolidated in the applicable financial statement, but the taxpayer's interest in the corporation is accounted for using the equity method, the taxpayer's net book income is adjusted to remove the effect of the corporation's inclusion under the equity method.

Where a corporation is included in the taxpayer's consolidated tax return for the year, but is included in the applicable financial statement measure of net income only when dividends are paid, the taxpayer's net book income must be adjusted to eliminate any dividends from the corporation.

The financial statement preference is a measurement of the amount by which pretax financial statement income of the taxpayer exceeds its alternative minimum taxable income. Thus, it is necessary to remove items of financial statement income and expense that relate to Federal or foreign income taxes (i.e., foreign taxes, however denominated, that are eligible for the foreign tax credit). This includes both items of tax provision that are separately stated and any items of tax expense or benefit that may be included in other items of income or expense. Such other items must be restated separately from their tax components for the purpose of computing adjusted net book income. Any provision for State and local taxes is considered allowable for the purpose of computing adjusted net book income and no adjustment is made to remove these items in determining book income. If the taxpayer elects to deduct foreign income taxes, rather than claim a credit, the foreign income taxes are treated in the same manner as State and local taxes.

In the case of a corporation that uses a different accounting year for financial statement purposes than the taxable year it uses for Federal income tax purposes, it is anticipated that an adjustment to net book income will be required in order to conform the financial accounting and taxable years for the purpose of computing adjusted net book income. Generally, the corporation will be required to include a pro rata portion of each financial statement accounting year that includes the Federal income tax taxable year. The use of a 52-53 week year will be considered to be the use of the annual year that ends during the same week as the 52-53 week year ends.

For example, a taxpayer uses a June accounting year and a calendar taxable year. For the taxable year ending December 31, 1988, the taxpayer would include one-half of the adjusted net book income for its accounting year ending June 30, 1988 and one-half of its adjusted net book income for its accounting year ending June 30, 1989.

It is anticipated that, if an applicable financial statement for an accounting year that is to be included on a pro rata basis is not available by the time for filing of a taxpayer's Federal income tax return (including any extensions), a reasonable estimate of the amount of adjusted net book income to be included will be made, and that the taxpayer's Federal income tax return will be amended to reflect the pro rata amount when the applicable financial statement is available. It is also anticipated that, if an accounting year that must be included on a pro rata basis has not ended by the time for filing of a taxpayer's Federal income tax return (including

extensions), the Secretary may prescribe circumstances in which an election will be made available to use adjusted net book income for the accounting year that ends within the taxpayer's taxable year in lieu of making this adjustment. Such an election, once made, would be irrevocable other than with the consent of the Secretary.

Extraordinary items are included in adjusted net book income unless they are items of tax benefit or expense, such as the use of a foreign tax or net operating loss carryforward. Extraordinary items that are stated net of tax must be adjusted to remove any Federal or foreign income tax expense or benefit components before the extraordinary item is included in adjusted net book income.

The committee bill provides the Secretary of the Treasury with the authority to issue regulations requiring the adjustment of net book income to prevent the omission or duplication of any item. It is anticipated that this grant of authority will be used, for example, to prevent the recording of items directly to the financial statement asset, liability, or equity accounts that are properly included as items of financial statement income or expense. It is also anticipated that this grant of authority will be used to prevent the use of asset, liability or equity accounts to offset items of income or expense that would otherwise not be allowed.

For example, taxpayers may restate prior year financial statements rather than making adjustments to the financial statement for the current period (a prior period adjustment). To prevent the manipulation of book income for the purposes of this provision, it is intended that book income for the current year be adjusted by the cumulative effect of the prior period adjustment on retained earnings or other equity account. However, this adjustment to book income shall be made only to the extent that the prior period adjustment pertains to a period occurring on or after the effective date of this provision.

Other taxpayers might seek to claim depreciation deductions in excess of the basis of the asset, offsetting such additional financial statement depreciation expense with a contra-asset account. It is anticipated that regulations would prevent this type of overstated financial statement expense.

The committee does not intend otherwise to interfere with the choice of a reasonable accounting method by the taxpayer, to require that certain accounting principles be applied, or to establish the Secretary of the Treasury as an arbiter of acceptable accounting principles.

It is expected that the Secretary of the Treasury will interfere in the taxpayer's choice of accounting methods only where such methods result in the omission or duplication of items of income or expense. For example, it is anticipated that taxpayers that compute net income for the purpose of their financial statements in accordance with tax accounting rules will be allowed to continue to do so.

Computation

The alternative minimum taxable income of a corporation for a taxable year includes one-half of the amount by which the adjusted net book income of the taxpayer exceeds the alternative minimum taxable income of the taxpayer before any amount is added to alternative minimum taxable income as a result of this preference.

For this purpose, a positive amount is considered to exceed any negative amount and a smaller negative amount is considered to exceed any larger negative amount.

For example, taxpayer A has adjusted net book income of $100 and alternative minimum taxable income (prior to the inclusion of any amount as a result of this preference) of $50. Adjusted net book income exceeds the alternative minimum taxable income by $50, one-half of which ($25) is added to alternative minimum taxable income to give an alternative minimum taxable income for the year of $75.

Taxpayer B has adjusted net book income of $100 and alternative minimum taxable income (prior to the inclusion of any amount as a result of this preference) of negative $50. In this case, adjusted net book income exceeds alternative minimum taxable income by $150, one-half of which ($75) must be added to alternative taxable income, resulting in alternative minimum taxable income for the year of $25.

Taxpayer C has adjusted net book income of negative $100 (a loss of $100) and alternative minimum taxable income (prior to the inclusion of any amount as a result of this preference) of negative $200. The adjusted net book income exceeds alternative minimum taxable income by $100, one-half of which ($50) is added to alternative taxable income, resulting in alternative minimum taxable income for the year of negative $150.

5. Alternative minimum tax itemized deductions for noncorporate taxpayers

In general, the alternative minimum tax itemized deductions for noncorporate taxpayers are the same as those under the present law alternative minimum tax. Thus, the only "below the line" deductions allowable are deductions for casualty and gambling losses, charitable contributions, medical expenses, qualified interest, and the estate tax deduction under section 691(c) (and, in the case of an estate or trust, for certain distributions to beneficiaries). In the case of qualified interest, present law is changed in two respects. First, as under section 163(d), limiting deductions for investment interest under the regular tax, it is clarified that limited business interests are included in the calculation. Thus, items of income and deduction relating to such interests are considered in determining the amount of qualified investment income and qualified investment expenses, respectively, and interest deductions relating to such interests are treated as itemized deductions (and subject to disallowace) for purposes of the rule. Second, no minimum tax itemized deduction is allowed with respect to consumer interest (even if it would be allowable if treated as investment interest).

6. Tax credits

Minimum tax credit

When a taxpayer pays alternative minimum tax, the amount of such tax paid (i.e., the net minimum tax) generally is allowed as a credit against the regular tax liability (net of other nonrefundable credits) of the taxpayer in subsequent years. However, the minimum tax credit cannot be used to reduce minimum tax liability in

subsequent years. The minimum tax credit can be carried forward indefinitely; thus, it is not necessary for the taxpayer to determine which prior year's minimum tax credit is being used in a particular year. The minimum tax credit cannot be carried back.

In the case of an acquisition of assets of a corporation by another corporation to which section 381(a) applies (for example, a statutory merger), any unused mnimum tax credits of the acquired corporation will be treated as a "tax attribute" that is taken into account by the acquiring corporation. However, for such an acquisition, as well as an acquisition of stock, the availability of the credits may be subject to limitation under the provisions of Part V of Subchapter C (sections 381 through 383).

The minimum tax credit is allowed only with respect to liability arising as a result of deferral preferences (i.e., preferences other than those that result in permanent exclusion of certain income for regular tax purposes). Thus, the amount of the net minimum tax is reduced by the amount of minimum tax liability that would have arisen if the only applicable preferences were the exclusion preferences. The exclusion preferences are those relating to percentage depletion and regular tax itemized deductions that are denied for minimum tax purposes.[12]

Consider, for example, the case of married taxpayers filing a joint return with (i) no regular taxable income, (ii) deferral preferences in the amount of $400,000, and (iii) exclusion preferences (including any disallowed itemized deductions) in the amount of $100,000. Under the 20 percent alternative minimum tax rate, and in light of the phase-out of the exemption amount, minimum tax liability would equal $100,000. However, if the taxpayers had had only exclusion preferences, minimum tax liability would have equalled $12,000 (20 percent of $100,000 as reduced by the $40,000 exemption amount). Thus, the amount of minimum tax available as a carryforward credit would be $88,000 ($100,000 less $12,000).

Foreign tax credit

Under the bill, minimum tax liability is defined as the excess of the tentative minimum tax (i.e. 20 percent of the excess of alternative minimum taxable income over the exemption amount, reduced by the specially computed foreign tax credit using the minimum tax base) over the regular tax (i.e. regular tax liability reduced by the foreign tax credit). The foreign tax credit thus is, in effect, allowable for purposes of the alternative minimum tax, under rules similar to those applying to the alternative minimum tax on individuals under present law. These rules involve separate application, for minimum tax purposes, of the section 904 limitation on the amount of the credit, to reflect the differences between regular taxable income and alternative minimum taxable income.

For example, to the extent that preferences allocable to U.S. source income, when taken into consideration for minimum tax purposes, change the ratio of foreign taxable income to worldwide income, the application of section 904 may lead to different results

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[12] For this purpose, the book income preference is treated as a deferral preference, notwithstanding that some differences between alternative minimum taxable income and book income may result from exclusion items (such as tax-exempt interest).

under the regular and the alternative minimum taxes, respectively. In light of these differences, taxpayers must separately keep track of the amount of foreign tax credit carryforwards allowable for regular and for minimum tax purposes.

In applying section 904 for minimum tax purposes with respect to an amount added to alternative minimum taxable income with respect to the book income of a corporate taxpayer, the committee intends that the percentage of such income that is from sources within the United States will be treated as the same as the percentage of all other alternative minimum taxable income for the taxable year of the taxpayer that is from sources within the United States. Thus, in effect, the book income preference will not result in any change in the percentage applying for purposes of the alternative minimum tax section 904 limitation.

In addition to being limited by section 904, use of the foreign tax credit is limited for minimum tax purposes by a rule designed to prevent U.S. taxpayers with substantial income from using the foreign tax credit to avoid all U.S. tax liability. Under this rule, no more than 90 percent of tentative minimum tax liability (before allowance of the foreign tax credit) can be offset by foreign tax credits, even if under section 904 more than 90 percent of such liability could be offset by such credits. This rule has no effect on a taxpayer who already is prevented by section 904 from offsetting more than 90 percent of minimum tax liability with foreign tax credits. Any foreign tax credits that are disallowed under this rule are treated, for carryover purposes, like credits disallowed by reason of section 904. This rule, like the limitation under section 904, is applied prior to comparing the amount of the taxpayer's minimum tax liability with the amount of such taxpayer's regular tax liability.

Incentive tax credits

Nonrefundable credits other than the minimum tax credit generally are accorded treatment that is intended to have the same effect as the rules applying under the present law alternative minimum tax on individuals. However, the rules have been revised in one technical respect in the interest of simplicity. Under present law, nonrefundable credits can be claimed against the regular tax even if they provide no benefit (i.e., they reduce regular tax liability to less than the amount of minimum tax liability that was due in any case). To the extent that the credits provide no benefit due to the minimum tax, however, they are allowed as carryovers to other taxable years.

Under the bill, such credits generally cannot be claimed in the first place to the extent that they would reduce regular tax liability to less than tentative minimum tax liability and hence provide no benefit. As under present law, such credits are allowed as carryovers to other taxable years, under the generally applicable rules for credit carryovers.

Where no minimum tax is due and the minimum tax does not limit the use of incentive credits, the taxpayer is not required to file with his or her tax return a form showing minimum tax computations. For example, a taxpayer with $100 of regular tax liability (disregarding incentive credits), a targeted jobs tax credit in the

amount of $10, and whose tentative minimum tax equalled less than $90, would not be required to file a minimum tax form with the Internal Revenue Service.

The alternative minimum tax does not apply to any corporation that validly elects the application of section 936. Thus, a section 936 corporation is exempt from the alternative minimum tax, even to the extent that it has preference income that is not qualified possession source income.

7. Net operating losses

Under the bill, special rules apply for net operating losses. These rules generally are the same as the present law rules with respect to the alternative minimum tax for individuals.

For purposes of the alternative minimum tax, net operating loss deductions are determined by using a separate computation of alternative minimum tax net operating losses and carryovers. Generally, this computation takes into account the differences between the regular tax base and the alternative minimum tax base.

The amount of the net operating loss (under section 172(c)) for any taxable year, for purposes of the alternative minimum tax, generally is computed in the same manner as the regular tax net operating loss, with two exceptions. First, the items of tax preference arising in that year are added back to taxable income (or, as with depreciation, adjustments relating to those items are made), and, second, for individuals, only those itemized deductions (as modified under section 172(d)) allowable in computing alternative minimum taxable income are taken into account. In computing the amount of deduction for years other than the year of the loss (i.e., carryover years), the recomputed loss is deducted from the alternative minimum taxable income (as modified under section 172(b)(2)(A)) in the carryover year (whether or not the taxpayer is subject to the minimum tax in that year).

For example, if in year one a taxpayer has $20,000 of income and $35,000 of losses, of which $10,000 are preference items, the alternative minimum tax net operating loss for the year is $5,000. Thus, in any subsequent (or prior) year to which the loss may be carried, a $5,000 net operating loss deduction is allowed to reduce income subject to the alternative minimum tax.

Assume that, in year two, the taxpayer has $20,000 of alternative minimum taxable income (without regard to the net operating loss deduction). The taxpayer reduces his or her alternative minimum taxable income to $15,000 by the minimum tax net operating loss deduction. The net operating loss deduction for the regular tax is not affected by this computation (i.e., the taxpayer has a loss carryover of $15,000 from year one to be used under the regular tax).

For corporations, a transition rule generally allows, for purposes of the alternative minimum tax, all pre-effective date regular tax net operating losses to be carried forward as minimum tax NOLs to the first taxable year for which the tax, as amended under the bill, applies (and to subsequent years until used up). For individuals, present law is retained with respect to the calculation of alternative minimum tax net operating losses for such years.

An adjustment is required in the case of a corporation that, as of the end of the last taxable year beginning before January 1, 1987,

had a deferred add-on minimum tax liability for a year prior to 1987, under section 56(b), due to certain net operating losses. For such a corporation, no add-on minimum tax liability will be imposed after 1986, but the alternative minimum tax net operating loss carried to the first taxable year of the corporation beginning after December 31, 1986, is reduced by the amount of the preferences that gave rise to the liability.

8. Regular tax elections

In the case of certain expenditures that would give rise to a minimum tax preference if treated under the rules generally applying for regular tax purposes, the taxpayer may make a "normative election," i.e., elect to have the minimum tax rule for deducting the expenditure apply for regular tax purposes. The expenditures to which this rule applies are the following: circulation expenditures, research and experimental expenditures, intangible drilling costs, and mining development and exploration expenditures. Elections may be made "dollar-for-dollar"; thus, for example, a taxpayer who incurs $100,000 of intangible drilling costs with respect to a single well may elect normative treatment for any portion of that amount.

To the extent that such an election applies, the item to which it applies is treated for all purposes, under both the regular and the minimum tax, pursuant to the election. No other deduction is allowed for the item to the extent that such an election applies.

An election made under this rule may be revoked only with the consent of the Secretary. Elections may be made at such time and in such manner as the Secretary by regulations prescribes. In the case of a partnership or S corporation, an election may be made separately by any partner (or shareholder) with respect to such individual's allocable share of any expenditure.

9. Other rules

The bill also contains certain miscellaneous rules affecting the application of the alternative minimum tax. For example, corporations are required to make estimated tax payments with respect to liability under the alternative minimum tax, in addition to the regular tax as under present law.

In the case of an estate or a trust, certain alternative minimum tax itemized deductions are allowable, and all items that are treated differently for regular and minimum tax purposes are to be apportioned between the estate or trust and the beneficiaries in accordance with regulations prescribed by the Secretary.[13]

Rules for allocating items that are treated differently for regular and minimum tax purposes, respectively, are also provided with respect to common trust funds, regulated investment companies, and real estate investment trusts.

In addition, rules are provided relating to certain technical issues such as short taxable years and the application of exemption amounts with respect to companies filing consolidated returns. Fi-

[13] The Secretary may also exercise regulatory authority, as appropriate, to permit adjustments to the book income preference in the case of corporate entities that may reduce regular taxable income with respect to distributions to owners.

nally, as under present law, the Treasury is authorized to prescribe regulations regarding the application of the tax benefit rule with respect to items that are treated differently for regular and minimum tax purposes, respectively.

Effective Date

The provisions apply to taxable years beginning after December 31, 1986.

Revenue Effect

With respect to individuals, the provision is estimated to increase fiscal year budget receipts by $406 million in 1987, $1,964 million in 1988, $1,607 million in 1989, $1,217 million in 1990, and $1,173 million in 1991.

With respect to corporations, the provision is estimated to increase fiscal year budget receipts by $3,902 million in 1987, $6,900 million in 1988, $7,061 million in 1989, $7,079 million in 1990, and $7,577 million in 1991.

TITLE XII—PENSIONS AND DEFERRED COMPENSATION; EMPLOYEE BENEFITS; EMPLOYEE STOCK OWNERSHIP PLANS (ESOPs)

A. Limitations on Treatment of Tax-Favored Savings

1. Individual Retirement Arrangements (IRAs) (secs. 1201-1204 of the bill and secs. 219, 265, and 408 of the Code)

Present Law

Under present law (Code sec. 219), an individual who has not attained age 70-1/2 generally is entitled to deduct from gross income (within limits) the amount contributed to an individual retirement arrangement (an IRA). The limit on the deduction for a taxable year generally is the lesser of $2,000 or 100 percent of compensation (earned income, in the case of income from self-employment).

Under a spousal IRA, an individual is allowed an additional deduction for contributions to an IRA for the benefit of the individual's spouse if (1) the spouse has no compensation for the year; (2) the spouse has not attained age 70-1/2; and (3) the couple files a joint income tax return for the year. If deductible contributions are made (1) to an individual's IRA and (2) to an IRA for the noncompensated spouse of the individual (a spousal IRA), then the annual deduction limit on the couple's joint return is increased to the lesser of $2,250 or 100 percent of compensation includible in gross income. The annual contribution may be divided as the spouses choose, so long as the contribution for neither spouse exceeds $2,000. If a spouse has a small amount of compensation, including amounts less than $250, the spousal IRA deduction is not available.

Prior to the Economic Recovery Tax Act of 1981 (ERTA), deductible IRA contributions were not permitted for any taxable year if an individual, for any part of the taxable year, was an active participant in a qualified pension, profit-sharing, or stock bonus plan (sec. 401(a)), a tax-sheltered annuity program (sec. 403(b)), a qualified annuity plan (sec. 403(a)), or a governmental plan (whether or not tax qualified). Nondeductible IRA contributions were not permitted.

ERTA provided that deductible IRA contributions (within limits) could be made by all individuals, without regard to whether an individual is covered under an employer's retirement plan.

Amounts withdrawn from an IRA prior to age 59-1/2, death, or disability of the owner of the IRA are subject to a 10-percent additional income tax (sec. 408(f)). (See, also, the discussion relating to Treatment of Distributions in Part C, below).

Further, under present law, no deduction is allowed for interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from tax (sec. 265(2)).

This provision does not apply to amounts borrowed to make IRA contributions because the interest on an IRA is not wholly exempt from tax, but instead the tax is deferred until income is withdrawn from the IRA.

Reasons for Change

The individual retirement savings provisions of the Code were originally enacted in the Employee Retirement Income Security Act of 1974 (ERISA) to provide a tax-favored retirement savings arrangement to individuals who were not covered under a qualified plan, a tax-sheltered annuity program, or a governmental plan maintained by their employer. At that time, individuals who were active participants in employer plans were not permitted to make deductible IRA contributions.

In the Economic Recovery Tax Act of 1981 (ERTA), Congress eliminated the active participant restriction and extended IRA availability to all taxpayers. At that time, the Congress articulated a concern about the level of savings generally and expressed a desire to provide a discretionary retirement savings arrangement that was uniformly available.

Since 1981, the expanded availability of IRAs has had no discernible impact on the level of aggregate personal savings. In addition, many employers have adopted qualified cash or deferred arrangements, which permit employees to make discretionary contributions that are provided with tax-favored treatment essentially equivalent to that accorded to deductible IRA contributions. The limits on elective deferrals under cash or deferred arrangements are substantially higher (even after the reductions included in the committee bill) than the limits on IRA contributions, but are subject to nondiscrimination rules designed to promote participation by lower-paid employees. In addition, many employees of tax-exempt organizations are permitted to make significant elective deferrals under tax-sheltered annuity programs. The committee believes that the wide availability of the option to make elective deferrals under cash or deferred arrangements and tax-sheltered annuities reduces the prior concern that individuals in employer-maintained plans should be able to save additional amounts for retirement on a discretionary basis.

Further, data have consistently shown that IRA utilization is quite low among lower-income taxpayers who may be the least likely to accumulate significant retirement saving in the absence of a specific tax provision. For example, for the 1984 tax year, only 7.8 percent of returns with adjusted gross income (AGI) under $30,000 (who represent 76 percent of all taxpayers) made IRA contributions, whereas 59 percent of returns with AGI of $50,000 or more made IRA contributions. It is clear, therefore, that utilization of the IRA deduction increases substantially as income increases.

The committee believes that those taxpayers for whom IRA utilization is the largest would generally have saved without regard to the tax incentives. The committee believes that the substantially lower tax rates provided by the bill, which will themselves stimulate additional work effort and saving, eliminate the need for IRA deductions for those who participate in other tax-favored retire-

ment plans. Thus, the committee finds it appropriate to reinstate the rules prior to ERTA, which limit IRA deductions to those taxpayers who are not covered by an employer-provided pension plan.

However, the committee also wishes to continue a tax incentive for discretionary retirement savings. Therefore, the committee bill permits individuals who are covered by an employer's retirement plan to make nondeductible contributions to an IRA with a continued deferral of tax on the earnings on these nondeductible contributions.

In addition, the committee recognizes that the current spousal IRA deduction limit creates anomalous results in the case of a spouse whose earned income is less than $250 a year. The committee's bill eliminates this anomaly for purposes of determining eligibility to make deductible or nondeductible spousal IRA contributions.

The committee also finds it appropriate, without regard to the general limits on deductibility of interest in the bill, to limit deductions for interest on loans used to fund deductible or nondeductible IRA contributions. Tax incentives for IRAs should not be available in cases in which it is clear that IRAs do not produce a net increase in savings.

Explanation of Provisions

IRA deduction not available to active participants

Under the bill, no deductible IRA contribution could be made for any taxable year if an individual is an active participant in an employer-maintained retirement plan for any part of the plan year ending with or within the individual's taxable year. For purposes of this rule, an employer-maintained retirement plan means (1) a qualified pension, profit-sharing, or stock bonus plan, (2) a qualified annuity plan (sec. 403(a)), (3) a simplified employee pension (sec. 408(k)), (4) a plan established for its employees by the United States, by a State or political subdivision, or by any agency or instrumentality of the United States or a State or political subdivision, or (5) a plan described in section 501(c)(18). In addition, an individual is not permitted to make deductible IRA contributions if amounts are contributed, on an elective or nonelective basis, on the individual's behalf by an employer for a tax-sheltered annuity (sec. 403(b)).

The determination of whether an individual is an active participant or whether amounts are contributed on the individual's behalf is made without regard to whether the individual's rights to benefits under a plan are nonforfeitable. Further, the determination of active participant status is dependent upon the type of plan in which the individual participates or is eligible to participate.

In the case of a defined benefit pension plan, an individual is treated as an active participant if the individual is not excluded under the eligibility requirements under the plan for any part of the plan year ending with or within the individual's taxable year. Thus, for example, if an individual satisfies the conditions for eligibility under a defined benefit pension plan, but is required to make an employee contribution to accrue any benefit attributable to employer contributions under the plan, the individual is treated as an

active participant even if no employee contribution is made and, thus, no benefit is accrued for the plan year.

Under a money purchase pension plan, an individual is an active participant if any employer contribution is required to be allocated to the individual's account with respect to the plan year ending with or within the individual's taxable year, even if the individual is not employed at any time during the plan year (e.g., contributions are continued on behalf of a permanently disabled employee (sec. 415(c)(3)(C)) or the individual's taxable year (e.g., the individual separates from service before the beginning of the taxable year).

An individual is treated as an active participant under a profit-sharing or stock bonus plan if any employer contribution is added or any forfeiture is allocated to the individual's account during the individual's taxable year. A contribution is added to an individual's account on the later of the date the contribution is made or is allocated.

Finally, an individual is treated as an active participant for any taxable year in which the individual makes a voluntary or mandatory employee contribution. An individual is not treated as an active participant if earnings (rather than contributions or forfeitures) are allocated to the individual's account.

Nondeductible contributions permitted to IRAs

Under the bill, individuals who are active participants (and who, therefore, are not eligible to make deductible IRA contributions for a taxable year) may make designated nondeductible IRA contributions. The limit on designated nondeductible contributions for a taxable year is the lesser of 100 percent of compensation (earned income in the case of a self-employed individual) or $2,000 ($2,250 in the case of an additional contribution to a spousal IRA).

A designated nondeductible contribution is any contribution to an IRA for a taxable year that does not exceed the nondeductible limit and that the individual designates as a nondeductible contribution. The designation may be made or revoked up to the due date for filing the individual's tax return for the year.

The committee intends that the individual's designation of nondeductible contributions will be made to the trustee or issuer accepting the IRA contributions at the time of such contribution. This rule is provided to aid the trustee or issuer in maintaining records relating to the characterization of IRA contributions as nondeductible contributions, income on nondeductible contributions, and other amounts. The designation is also intended to assist the trustee or issuer in complying with reporting requirements applicable to IRAs. With respect to the annual reporting requirements of present law, the committee expects that the financial institution, when reporting contributions to an IRA to the Internal Revenue Service, will specify whether the contribution is a designated nondeductible contribution.

The trustee or issuer may specify a uniform date by which a designation must be made. For example, the trustee or issuer could require a designation at the time a contribution is made or, alternatively, could specify a uniform date (such as April 15) for designations.

Under the bill, any amount paid, distributed, or transferred from an IRA that has received designated nondeductible IRA contributions is treated as part nondeductible contributions and as part earnings on such nondeductible contributions, based on the fair market value of the IRA at the time of distribution. This treatment of amounts withdrawn is available only if (1) the trustee or issuer separately accounts for earnings attributable to nondeductible IRA contributions within an IRA (by the establishment of a bookkeeping subaccount) or the nondeductible contributions plus earnings are the only contributions held in the IRA, and (2) in the case of withdrawals from an IRA to which both deductible and nondeductible contributions have been made, the individual designates the withdrawal as attributable to nondeductible contributions and earnings thereon. If the individual fails to designate that a withdrawal is attributable to nondeductible contributions or if the trustee or issuer fails to maintain a separate bookkeeping subaccount with respect to nondeductible contributions, any withdrawals are treated first as distributed out of deductible contributions and earnings thereon.

For purposes of determining the fair market value of an IRA, the committee intends that the Secretary may permit the use of an annual, quarterly, or monthly valuation date in situations in which the value of the IRA on the date of distribution or transfer is not readily ascertainable. Under such circumstances, a prior valuation date similar to the valuation date permitted to be used for purposes of distributions from or under a qualified plan could be used.

In general, any amount paid or distributed that is a return of nondeductible contributions is treated as a nontaxable return of basis. If the individual rolls over to another IRA all or any part of the amount paid or distributed, the amount rolled over is treated as attributable to the nondeductible contributions in the same proportion as the amount paid or distributed was a return of nondeductible contributions.

The committee intends that the trustee or issuer of an IRA will provide a statement to an individual (with a copy to the IRS) when an amount is paid or distributed from an IRA specifying the portion of any distribution that is a return of nondeductible contributions. In addition, the committee intends that a copy of this statement is to be supplied to the trustee or issuer of an IRA to which a rollover contribution is made so that the character of the amounts rolled over is retained. Similarly, at any time a trustee-to-trustee transfer of IRA funds is made, any information relating to the character of the amounts transferred is to be supplied to the IRS and to the new trustee or issuer. This statement is required in addition to, and not in lieu of, the annual reporting requirement of present law.

Annual IRA contributions that exceed either the deductible limit or the nondeductible limit (whichever applies) are treated as excess contributions that are subject to an annual 6 percent excise tax (sec. 4973). Under the bill, if contributions in a later taxable year are less than the deductible or nondeductible limit for the taxable year, then the excess contributions for the earlier year may be applied against the limit for the current taxable year. Thus, under the bill, excess nondeductible contributions from a prior year could

be recharacterized as deductible contributions for the current year if the individual is no longer an active participant. Similarly, excess deductible contributions could be recharacterized as nondeductible contributions.

Spousal IRA deduction

Under the bill, the spousal IRA provision is amended to eliminate the requirement that the spouse have no compensation for the year in order to be eligible for the spousal IRA contribution. Therefore, under the bill, the spousal IRA is available (on a deductible or nondeductible basis, depending on whether the individual with earned income is an active participant for the taxable year) either if (1) the spouse has no compensation for the taxable year or (2) the spouse elects to be treated for the taxable year as having no compensation.

For purposes of this provision, if a spousal IRA contribution is specified on the couple's tax return for the taxable year, the spouse is deemed to have elected to be treated as having no compensation.

The treatment of a spousal IRA contribution as deductible or nondeductible depends on the status of the individual (with compensation for the taxable year) as an active participant. Thus, if a married individual with compensation is an active participant for a year and the individual's spouse has (or is treated as having) no compensation for the year, the couple may make a nondeductible IRA contribution of up to $2,250 for the year. If both spouses have compensation for a year but only the wife is an active participant, either (i) the wife may make a nondeductible IRA contribution of up to $2,250 for the couple; (ii) the wife may make a nondeductible IRA contribution of up to $2,000 for herself, and the husband may make a deductible IRA contribution up to $2,000 for himself; or (iii) the husband may make a deductible IRA contribution of up to $2,250 for the couple.

Interest on loans to make IRA contributions

Notwithstanding the general provisions of the bill limiting deductions for interest under certain circumstances, the bill provides that no deduction is allowed for interest on indebtedness incurred or continued to make an IRA contribution. Under the bill, the interest deduction is denied whether or not a deduction is allowed for the IRA contribution.

Qualified voluntary employee contributions

Under the bill, the rules permitting deductible employee contributions analogous to deductible IRA contributions are repealed. Therefore, individuals will no longer be permitted to make a qualified voluntary employee contribution to a qualified plan because permitting such contributions is inconsistent with the rules denying deductible IRA contributions for individuals who are active participants.

Additional income tax on early withdrawals

Under the bill, the additional income tax on early withdrawals is increased to 15 percent in the case of withdrawals attributable to deductible contributions and income therefrom. For details relating

to this provision, see the discussion in Part C, below, relating to the Treatment of Distributions.

Effective Dates

The provisions generally are effective for taxable years beginning after December 31, 1986.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $1,697 million in 1987, $5,186 million in 1988, $5,715 million in 1989, $6,207 million in 1990, and $6,704 million in 1991.

2. Qualified Cash or Deferred Arrangements (secs. 1205 and 1216 of the bill and secs. 401(k), 402, and 4979 of the Code)

Present Law

Under present law, if a tax-qualified profit-sharing or stock bonus plan (or an eligible pre-ERISA money purchase pension plan) meets certain requirements described below (a "qualified cash or deferred arrangement"), then an employee is not required to include in income any employer contributions to the plan merely because the employee could have elected to receive the amount contributed in cash.

Nondiscrimination requirements

Under present law, special nondiscrimination tests apply a limit on elective deferrals that may be made by the group of highly compensated employees. This limit depends (in part) on the level of elective deferrals by nonhighly compensated employees. An employee is considered highly compensated, for this purpose, if the employee is one of the most highly compensated 1/3 of all employees eligible to defer under the arrangement. These nondiscrimination tests provide that the special treatment of elective deferrals is not available unless the cash or deferred arrangement does not disproportionately benefit highly compensated employees.

The limit on elective deferrals by the highly compensated employees is based on the relationship of the actual deferral percentage for the group of highly compensated employees to the actual deferral percentage for the group of other employees. The deferral percentage for an employee for a year is the percentage of that employee's compensation that has been electively deferred for the year. The actual deferral percentage for a group of employees is the sum of the deferral percentages for the employees divided by the number of employees in the group. In the case of an eligible employee who does not make any deferrals under the arrangement during the year, the employee's deferral percentage is zero.

A cash or deferred arrangement meets these special nondiscrimination requirements for a plan year if (1) the actual deferral percentage for the highly compensated employees is not greater than 150 percent of the actual deferral percentage for the other eligible employees, or (2) the actual deferral percentage for the highly compensated employees does not exceed the lesser of (a) the actual deferral percentage for the other eligible employees plus three per-

centage points or (b) 250 percent of the actual deferral percentage for the other eligible employees. In calculating these deferral percentages, contributions by the employer may be taken into account as elective deferrals by employees if they (1) are nonforfeitable when made, (2) satisfy the withdrawal restrictions applicable to elective deferrals, and (3) separately satisfy the general nondiscrimination rules (sec. 401(a)(4)).

The special nondiscrimination tests applicable to cash or deferred arrangements apply in lieu of the usual nondiscrimination rules for qualified plans, which permit employer contributions to social security to be taken into account. These special nondiscrimination rules are not in lieu of the usual coverage rules requiring that a qualified cash or deferred arrangement cover either 70 percent of all employees or a nondiscriminatory classification of employees.

Withdrawal restrictions

Under present law, a participant in a qualified cash or deferred arrangement is not permitted to withdraw elective deferrals (and earnings thereon) prior to death, disability, separation from service, retirement, or (except in the case of a pre-ERISA money purchase pension plan) the attainment of age 59-1/2 or the occurrence of a hardship. Under proposed regulations, an employee would be treated as having incurred a hardship only to the extent that the employee has an immediate and heavy bona fide financial need and does not have other resources reasonably available to satisfy the need.[1]

Limit on elective deferrals

Elective deferrals under a qualified cash or deferred arrangement are subject to the overall limits on contributions to a defined contribution plan. Thus, under present law, the sum of an employee's elective deferrals and any other annual additions on behalf of the employee under all plans maintained by the employer generally cannot exceed the lesser of $30,000 or 25 percent of the participant's nondeferred compensation.

Reasons for Change

The committee is concerned that the rules relating to qualified cash or deferred arrangements under present law encourage employers to shift too large a portion of the share of the cost of retirement savings to employees. The committee is also concerned that the present-law nondiscrimination rules and permissible contribution levels permit significant contributions by highly compensated employees without comparable participation by rank-and-file employees.

The committee recognizes that individual retirement savings can play an important role in providing for the retirement income security of employees. The committee also believes that excessive reliance on individual retirement savings (relative to employer-pro-

[1] Prop. reg. sec. 1.401(k)-1(d)(2).

vided retirement savings) can result in inadequate retirement income security for many rank-and-file employees.

In particular, the committee believes that qualified cash or deferred arrangements should be supplementary retirement savings arrangements for employees; such arrangements should not be the primary employer-maintained retirement plan. Therefore, the committee believes that the extent to which employers can shift the burden of retirement saving to employees should be reduced. Moreover, the committee finds it necessary to restrict the extent to which employers can condition the receipt of other benefits on employees' elections to defer under a qualified cash or deferred arrangement.

Another way of achieving this goal is to limit the number of employers that can maintain cash or deferred arrangements. Thus, the committee believes it is appropriate to make qualified cash or deferred arrangements unavailable to State and local governments which currently are permitted to maintain a similar kind of elective contribution arrangement (i.e., a sec. 457 plan) and, in some cases, a tax-sheltered annuity.

Further, the committee emphasizes that, even if there were not a concern about the total amount of tax-favored savings that individuals could annually accumulate, the cap on annual contributions is necessary to provide a backstop that ensures the proper operation of the nondiscrimination rules applicable to qualified cash or deferred arrangements.

In addition, the committee believes that a basic reason for extending significant tax incentives to qualified pension plans is the delivery of comparable benefits to rank-and-file employees who may not otherwise save for retirement. Accordingly, the committee concludes that it is appropriate to revise the nondiscrimination rules for qualified cash or deferred arrangements by redefining the group of highly compensated employees in order to more closely achieve this goal.

Finally, the committee believes that it is necessary to restrict the availability of hardship withdrawals under a qualified cash or deferred arrangement to further the goal that favorable tax treatment be limited to savings that are, in fact, used to provide retirement income.

Explanation of Provisions

Limit on elective deferrals

In general

Under the bill, the maximum amount that an employee can elect to defer for any taxable year under all cash or deferred arrangements in which the employee participates is limited to $7,000. The $7,000 cap is adjusted for inflation by reference to percentage increases in the social security wage base at the same time and in the same manner as the indexing of dollar limits on benefits under section 415.

Whether or not an employee has deferred more than $7,000 a year is determined without regard to any community property laws. In addition, the $7,000 limit is coordinated with elective de-

ferrals under simplified employee pensions (SEPs). In addition, the benefits under an unfunded deferred compensation plan of a State or local government (sec. 457) and a plan described in section 501(c)(18) are coordinated with the limits on elective deferrals under a qualified cash or deferred arrangement or a SEP. Moreover, for purposes of determining an individual's cap on elective deferrals for a year, the $7,000 cap (as indexed) is reduced by the amount of the individual's contributions to a tax-sheltered annuity contract to the extent that the contributions are made pursuant to a salary reduction agreement.

Unlike the overall limits on annual additions, which apply separately to amounts accumulated under plans of unrelated employers, this $7,000 cap limits all elective deferrals by an employee under all cash or deferred arrangements, SEPs, and sec. 501(c)(18) plans in which the employee participates. In addition, the $7,000 cap applies on the basis of the employee's taxable year, rather than the plan's limitation year.

Because, under the bill, the $7,000 limit applies only to elective deferrals, each employer may make additional contributions on behalf of any employee to the extent that such contributions, when aggregated with elective deferrals made by the employee under that employer's plan during the limitation year, do not exceed the overall limit (generally the lesser of 25 percent of compensation or $30,000).

Treatment of excess deferrals

If, in any taxable year, the total amount of elective deferrals contributed on behalf of an employee to all qualified cash or deferred arrangements and SEPs in which the employee participates exceeds $7,000, then the amount in excess of $7,000 (the excess deferrals) is included in the employee's gross income for the year to which the excess deferrals relate. In addition, with respect to any excess deferrals, no later than the first March 1 after the close of the employee's taxable year, the employee may allocate the excess deferrals among the arrangements in which the employee participates and may notify the administrator of each plan of the portion of the excess deferrals allocated to it. Under the bill, not later than the first April 15 after the close of the employee's taxable year, each plan may distribute to the employee the amount of the excess deferrals (plus income attributable to the excess) allocated to the plan. This distribution of excess deferrals may be made notwithstanding any other provision of law.

The committee intends that, to ease the administrative burden on employees and employers and the IRS, the arrangements maintained by any single employer may preclude an employee from making elective deferrals under such arrangements for a taxable year in excess of $7,000. To the extent that excess deferrals are made to arrangements of an employer, all amounts contributed in excess of the annual cap shall be treated as after-tax employee contributions.

The amount of excess deferrals distributed to an employee (plus the income thereon) are included in the employee's gross income for the year to which the excess deferrals relate. Thus, the amounts distributed are treated as if they had not been contributed

to the qualified cash or deferred arrangement and are not subject to any additional income taxes for early withdrawals. However, such excess deferrals are taken into account in applying the special nondiscrimination tests to the elective deferrals. The committee intends that the Secretary may require the recalculation of the actual deferral percentages after the distribution of excess deferrals in certain cases.

Excess deferrals that are not distributed by the applicable April 15 date are not treated as after-tax employee contributions upon subsequent distribution even though such deferrals were included in the employee's income. In addition, undistributed excess deferrals are treated as elective deferrals subject to the special nondiscrimination test.

The following example illustrates the application of the elective deferral limitation. Assume that, in 1987, employee A (whose taxable year is the calendar year) electively defers $5,000 under employer X's qualified cash or deferred arrangement and $3,000 under employer Y's qualified cash or deferred arrangement. For 1987, employee A may exclude from gross income only $7,000 of the total $8,000 of elective deferrals. The $1,000 excess deferral may be withdrawn from X's plan or Y's plan, or partially from both plans. A can request that $750 (plus income allocable to $750) be distributed from X's plan and that $250 (plus income allocable to $250) be distributed from Y's plan.

If the $1,000 of excess deferrals (plus income allocable to the $1,000) is distributed by April 15, 1988, A is required to include the excess (plus income) in gross income for 1987. The amount distributed would not then be included in gross income again in 1988. Further, A would not be subject to the 15-percent additional income tax on withdrawals prior to age 59½.

Finally, employers X and Y are required, except to the extent provided by regulations, to take the distributed amounts into account when they test their qualified cash or deferred arrangements under the nondiscrimination tests for the year to which the excess relates.

If either of the plans fails to make the requested distribution by April 15, 1988, then the excess deferrals are to remain in the qualified cash or deferred arrangement, subject to the general withdrawal restrictions applicable to such arrangements. In addition, notwithstanding that A included the excess deferrals in gross income for 1987, A will not be treated as having any investment in the contract on account of the excess deferrals that were not distributed. Thus, the full amount of the excess deferrals not distributed will again be included in income when actually distributed from the arrangement. Further, the undistributed excess deferrals will be taken into account as elective deferrals in applying the special nondiscrimination tests applicable to the cash or deferred arrangement.

Special limitation for investment in employer securities

Under the bill, the $7,000 cap (as indexed) on elective deferrals is increased by up to $2,500 in the case of certain investments in employer securities. The amount of the increase in the annual cap for an individual equals the lesser of (1) $2,500 or (2) the amount of

elective deferrals for the year invested in employer securities and held by an ESOP (described in sec. 4975(e)(7) or meeting the requirements of sec. 409(l)).

The bill provides that the qualified cash or deferred arrangement is required to allow all eligible participants to have up to $2,500 of elective deferrals invested in employer securities before the additional limitation is available. In addition, the employer securities allocated to the account of a participant whose elective deferrals for a year exceed $7,000 are required to remain so allocated during the 3-year period beginning with the year following the year in which the employer securities were allocated to a participant's account. If the employer securities cease to be allocated to the participant's account, then the securities are treated as if they were distributed to the participant on the date the securities cease to be allocated to the participant's account.

The committee intends that the plan administrator will either (1) notify plan participants of the consequences of failing to earmark the employer securities as part of the participant's investment for 3 years, or (2) require that employer securities remain allocated for 3 years.

Nondiscrimination requirements

In general

The bill modifies the special nondiscrimination tests applicable to qualified cash or deferred arrangements by (1) clarifying the rules for aggregating elective contributions with certain nonelective contributions for purposes of the special nondiscrimination test; (2) redefining the group of highly compensated employees; (3) establishing a mechanism for the return of contributions that violate the special nondiscrimination test; and (4) imposing an excise tax on contributions that violate the special nondiscrimination test if such excess contributions are not returned (or forfeited) within a specified period of time.

Aggregation with certain nonelective contributions

As under present law (Prop. Reg. sec. 1.401(k)-1(b)(2)), certain qualified matching contributions with respect to elective deferrals under a qualified cash or deferred arrangement may be taken into account in determining whether the special nondiscrimination test for a qualified cash or deferred arrangement is satisfied. Qualified matching contributions are employer matching contributions that (1) are nonforfeitable when made, and (2) satisfy the restrictions on distributions of elective deferrals from qualified cash or deferred arrangements (sec. 401(k)(2)).

In addition, the bill provides that nonelective employer contributions that meet the same vesting and distribution requirements as qualified matching contributions may also be taken into account in applying the special nondiscrimination test for qualified cash or deferred arrangements. There is an exception to the rule that qualified matching contributions and nonelective contributions may be taken into account as described above. Under this exception, such contributions may not be taken into account if, when such contributions are otherwise disregarded, other contributions fail to satis-

fy the applicable nondiscrimination rules (sec. 401(a)(4) or 401(m)). In other words, the committee does not intend that contributions may be taken into account more than once in testing for nondiscrimination.

Under the bill, if a highly compensated employee elects to defer under more than one qualified cash or deferred arrangement of an employer, such employee's elective deferrals are aggregated for purposes of applying the special nondiscrimination test under each arrangement. Of course, the committee intends that an employer will be permitted to elect to aggregate all employees under more than one qualified cash or deferred arrangement for purposes of applying the special nondiscrimination test. If the employer so elects, the arrangements are to be treated as a single qualified cash or deferred arrangement.

Definition of highly compensated employees

In general.—Under the bill, an employee is treated as highly compensated with respect to a year if, at any time during the year or the preceding year, the employee (1) was a 5-percent owner of the employer (as defined in sec. 416(i)); (2) earned more than $100,000 in annual compensation from the employer; (3) earned more than $50,000 in annual compensation from the employer and was a member of the top-paid group of the employer during the same year; or (4) was an officer of employees (as defined in sec. 416(i)). The $50,000 and $100,000 thresholds are indexed by reference to the method, as of May 1, 1986, of adjusting for percentage increases in the social security taxable wage base (i.e., at the same time and in the same manner as the adjustments to the dollar limits on benefits for defined benefit pension plans).

The identity of the highly compensated employees is to be determined on a controlled group basis. The employees who are treated as highly compensated employees are to be determined on a controlled group basis.

Top-paid group.—The bill provides that the top-paid group of employees includes all employees who are in the top 20 percent of the employer's workforce on the basis of compensation paid during the year. Under a special rule, an employer may exclude certain employees in determining the size of the employer's workforce for purposes of calculating the number of employees who are in the top 20 percent of employees.

Under the bill, the following employees may be excluded solely for purposes of determining the size of the top-paid group (but not for identifying the particular employees in the top-paid group): (1) employees who have not completed 180 days of service; (2) employees who work less than half-time; (3) employees who normally work fewer than 6 months a year; (4) except to the extent provided in regulations, employees who are included in a unit of employees covered by a collective bargaining agreement; (5) employees who have not attained age 21; and (6) employees who are nonresident aliens and who receive no U.S. source earned income. An example of an instance in which it is appropriate to consider employees covered by a collective bargaining agreement is the case in which the plan being tested is maintained pursuant to a collective bargaining agreement.

For purposes of this special rule, an employer may elect to apply numbers (1), (2), (3), and (5) above by substituting any shorter period of service or lower age than is specified in (1), (2), (3), or (5), as long as the employer applies the test uniformly for purposes of determining its top-paid group with respect to all its qualified plans and employee benefit plans (and for purposes of the line of business rules described below).

For example, assume, an employer's total workforce is 100 employees, 20 of whom have not completed 180 days of service. Assume that none of the 100 employees is within any of the other excluded categories under this rule. Under the above rules for determining the top-paid group, 16 employees may be treated as included in the top-paid group. This occurs because the 20 employees who have not completed the minimum requirements for eligibility may be disregarded in determining the size of the top-paid group. The top-paid group cannot be larger than 20 percent of 80 employees (the number of employees who are not disregarded). Thus, the 16 employees of the employer that earn the highest compensation (including any employees who have not completed 180 days but who are among the 16 highest paid employees of the employer) are to be treated as in the top-paid group. Each of these 16 employees in the top-paid group who earns more than $50,000 a year is treated as a highly compensated employee. Other employees (and any of the 16 employees earning less than $50,000) may also be a highly compensated employee under one of the other tests (e.g., officer or 5-percent owner).

Special rule for determining top-paid group for current year.—The bill provides that an employee will not be treated as in the top-paid group, as an officer, or as earning more than $50,000 or $100,000 solely because of the employee's status during the current year unless such employee also is among the 100 employees who have earned the highest compensation during such year. Under this rule, an individual who was a highly compensated employee for the preceding year (without regard to one-year lookback or to the application of this special rule) remains highly compensated for the current year. Thus, the 100-employee rule is intended as a rule of convenience to employers with respect to new employees hired during the current year, with respect to increases in compensation, and with respect to certain other factors. If any employee is not within the top-100 employees by pay for the current year (and was not a highly compensated employee in the preceding year), then that employee is not treated as highly compensated for the year, but will be treated as highly compensated for the following year if the employee otherwise falls within the definition of highly compensated employee.

For example, assume that a calendar year employer has 12,000 total employees in 1990 and in 1991, and for each year 4,000 employees may be disregarded in determining the number of employees that is to be treated as the number in the top-paid group. Thus 1,600 (20 percent of 8,000) employees are in the top-paid group. This employer's highly compensated employees for 1991 will include the following:

(1) Any employee who owned at any time during 1990 or 1991 more than 5 percent of the employer;

(2) Any employee who, in 1990, (i) earned more than $100,000 in annual compensation, (ii) was an officer (for top-heavy purposes), or (iii) earned more than $50,000 in annual compensation and was among the 1,600 most highly compensated employees; and

(3) Any employee who, in 1991, (i) was an officer (for top-heavy purposes) or earned more than $50,000 in annual compensation, and (ii) was among the 100 most highly compensated employees.

Thus, an employee who is not a highly compensated employee in 1990 (without regard to this special 100-employee rule) will not be treated as highly compensated for 1991 unless such employee either (i) acquires ownership of more than 5 percent of the employer in 1991 or (ii) both becomes an officer or earns more than $50,000 in 1991 and becomes one of the 100 most highly compensated employees in 1991.

The bill provides a special rule for determining the the highly compensated employees in the case of a certain employer. Under this special rule, if more than one half of the employees in the top 20 percent of employees by pay earn less than $25,000 (indexed), then members of the top-paid group is determined without regard to whether they earn more than $50,000.

Treatment of family members.—The bill provides a special rule for the treatment of family members of certain highly compensated employees. Under the special rule, if an employee is a family member of either a 5-percent owner or one of the top 10 highly compensated employees by compensation, then any compensation paid to such family member and any contribution under the plan on behalf of such family member is aggregated with the compensation paid and amounts contributed on behalf of the 5-percent owner or the highly compensated employee in the top 10 employees by pay. Therefore, such family member and employee are treated as a single highly compensated employee in applying the special nondiscrimination tests.

For example, if the spouse of the most highly compensated employee of an employer is also an employee and participates in the employer's qualified cash or deferred arrangement, the elective deferrals made by the spouse and the compensation earned by the spouse are aggregated with the elective deferrals made by, and the compensation earned by, the most highly compensated employee solely for purposes of applying the special nondiscrimination test to the elective deferrals of the most highly compensated employee.

An individual is considered a family member if, with respect to an employee, the individual is a spouse, lineal ascendant or descendant, or spouse of a lineal ascendant or descendant of the employee.

Former employees.—An employee who has separated from service continues to be treated as a highly compensated employee if the individual was a highly compensated employee when the employee separated from service. For purposes of this rule, an employee is treated as highly compensated if the employee was highly compensated at any time during the current or the preceding year. In addition, the Secretary is to prescribe rules to treat other former employees as highly compensated employees, if appropriate.

In addition, the committee is concerned that an individual may attempt to avoid these rules by continuing to perform a small

amount of services for the employer after retirement and, therefore, argue that separation from service has not occurred. Therefore, the committee intends that the Secretary of the Treasury shall prescribe rules to treat an individual as separated from service if the employee performs only de minimis services for the employer during the year.

Excess contributions

If the special nondiscrimination rules are not satisfied for any year, the bill provides that the cash or deferred arrangement will not be disqualified if the excess contributions (plus income allocable to such contributions) are distributed before the close of the following plan year. Such distribution may be made notwithstanding any other provision of law and is not subject to the additional tax on early distributions.

Under the bill, excess contributions mean, with respect to any plan year, the excess of (1) the aggregate amount of elective deferrals paid to the cash or deferred arrangement and allocated to the accounts of highly compensated employees, over (2) the maximum amount of elective deferrals that could be allocated to the accounts of highly compensated employees without violating the nondiscrimination requirements applicable to the arrangement. The bill provides that excess contributions are required to be distributed in a manner which ensures that the special nondiscrimination test will be satisfied. To determine the amount of excess contributions and the employees to whom the excess contributions are to be distributed, the bill provides that the elective deferrals of highly compensated employees are reduced in the order of their actual deferral percentages beginning with those highly compensated employees with the highest actual deferral percentages. The excess contributions are to be distributed to those highly compensated employees for whom a reduction is made under the preceding sentence in order to satisfy the special nondiscrimination tests.

For example, assume that the elective deferrals by the three highly compensated employees—A, B, and C—of employer X as of the close of the 1987 plan year are 10 percent, 8 percent, and 6 percent of compensation, respectively. Assume further that the actual deferral percentage limit on elective deferrals for the highly compensated employees in the qualified cash or deferred arrangement for the 1987 plan year is 7 percent.

The following method is to be utilized to determine the amount of excess contributions and the employees to whom the excess contributions are to be distributed. The elective deferrals by the highly compensated employees with the highest deferral ratios are treated as excess contributions to the extent that reducing such deferrals is necessary to bring the arrangement into compliance with the special nondiscrimination test. In this example, in order to reduce the actual deferral percentage for the highly compensated employees to 7 percent, it is necessary, first, to reduce the elective deferrals of employee A from 10 percent to 8 percent and, second, to reduce the elective deferrals of employees A and B from 8 percent to 7.5 percent. Thus, elective deferrals in excess of 7.5 percent are to be treated as excess contributions.

Excise tax on excess contributions

Under the bill, an excise tax is imposed on the employer making excess contributions to a qualified cash or deferred arrangement (sec. 4979). The tax is equal to 10 percent of the excess contributions under the arrangement for the plan year ending in the taxable year. However, the tax does not apply to any excess contributions that, together with income allocable to the excess contributions, are distributed no later than 2-1/2 months after the close of the plan year to which the excess contributions relate.

Excess contributions (plus income) distributed within the applicable 2-1/2 month period are to be treated as received and earned by the employee in the employee's taxable year in which the excess contributions, but for the employee's deferral election, would have been received as cash. Under the bill, the first elective deferrals for the plan year will be treated as the excess contributions. If the excess contributions (plus income) are distributed after the 2-1/2 month period and before the close of the subsequent plan year, such amounts are to be included in the employee's income in the taxable year of distribution (rather than in a prior taxable year). If the distribution is not made within the 2-1/2 month period, the employer will be subject to the 10-percent excise tax on excess contributions.

Other restrictions

The bill modifies certain present-law restrictions and imposes several additional restrictions on qualified cash or deferred arrangements.[2] First, the bill provides that distributions may be made to a participant in a qualified cash or deferred arrangement on account of the sale of a subsidiary or termination of the plan of which the arrangement is a part. Under the bill, the exception for distributions upon the sale of a subsidiary is available with respect to a participant who has not separated from service with the subsidiary.

The bill limits hardship withdrawals under a qualified cash or deferred arrangement to the amount of an employee's elective deferrals. Hardship withdrawals are not permitted from income on any contributions or from employer matching or nonelective employer contributions taken into account for purposes of the special nondiscrimination test and, as under present law, are not permitted from a pre-ERISA money purchase pension plan. Present-law standards relating to the definition of a hardship continue to apply.

In addition, the bill provides that a qualified cash or deferred arrangement cannot require, as a condition of participation in the arrangement, that an employee complete a period of service with the employer (or employers) maintaining the plan in excess of one year of service.

Under the bill, an employer generally may not condition, either directly or indirectly, contributions and benefits (other than matching contributions) upon an employee's elective deferrals. For example, if an employee's participation in a defined benefit pension plan depends upon whether the employee makes deferrals under a cash

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[2] *See*, also, the discussion in Part C., below.

or deferred arrangement, then the arrangement is not a qualified cash or deferred arrangement. Similarly, elective deferrals under a qualified cash or deferred arrangement may not be used to ensure that another plan, when combined with the cash or deferred arrangement, satisfies the usual coverage or nondiscrimination requirements (secs. 410(b) and 401(a)(4)). In addition, under the bill, a floor offset defined benefit pension plan may not provide for offsets attributable to elective deferrals under a qualified cash or deferred arrangement.

The bill provides that qualified cash or deferred arrangements are not available to employees of State or local governments.

Effective Dates

The provisions relating to (1) the annual limit on elective deferrals under qualified cash or deferred arrangements, (2) permitting distributions upon the sale of a subsidiary, (3) aggregating the elective deferrals of highly compensated employees for purposes of the special nondiscrimination tests, and (4) relating to the treatment of excess contributions generally are effective for years beginning after December 31, 1986. Other changes in the nondiscrimination requirements and other restrictions applicable to qualified cash or deferred arrangements generally are effective for plan years beginning after December 31, 1988.

The provision permitting distributions upon plan terminations is effective for terminations occurring in years beginning after December 31, 1984.

A special effective date applies to plans maintained pursuant to a collective bargaining agreement. Under this special rule, in the case of a plan maintained pursuant to a collective bargaining agreement between employee representatives and one or more employers ratified before March 1, 1986, the amendments are not effective for plan years beginning before the earlier of (1) the later of (i) January 1, 1989, or (ii) the date on which the last of the collective bargaining agreements terminates, or (2) January 1, 1991. Extensions or renegotiations of the collective bargaining agreement, if ratified after February 28, 1986, are disregarded. However, for purposes of applying the $7,000 cap to employees who participate in a collectively bargained plan and one or more other plans, elective deferrals under the collectively bargained plan will limit the amount the employee is permitted to defer under any other plan.

The bill provides a transition rule for the provision prohibiting State and local government employers from maintaining qualified cash or deferred arrangements. Under this rule, the provision does not apply to any cash or deferred arrangement maintained by a State or local government that was adopted by the employer before May 6, 1986.

The bill provides a special transition rule with respect to the prohibition on the use of elective deferrals under a cash or deferred arrangement as a condition to the receipt of any other benefits (other than employer matching contributions under the same plan). Under this rule, a cash or deferred arrangement will not be treated as violating this prohibition to the extent that the qualified cash or deferred arrangement is part of a "qualified offset arrangement"

with a defined benefit pension plan which offset arrangement was maintained by the employer on April 16, 1986.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $190 million in 1987, $344 million in 1988, $304 million in 1989, $300 million in 1990, and $317 million in 1991.

3. Nondiscrimination Requirements for Employer Matching Contributions and Employee Contributions (sec. 1217 of the bill and secs. 401 and 4979 of the Code)

Present Law

Under present law, a qualified plan may permit employees to make either after-tax or pre-tax contributions to a qualified plan. Employee contributions to a qualified plan may be voluntary or mandatory. Mandatory employee contributions include those made as a condition of obtaining employer-derived benefits (e.g., employee contributions made as a condition of obtaining employer matching contributions).

Present law provides that a qualified plan may not discriminate in contributions and benefits in favor of employees who are officers, shareholders, or highly compensated. Generally, this nondiscrimination requirement is satisfied with respect to employee contributions if all participants are entitled to make contributions on the same terms and conditions. In the past, voluntary employee contributions have been permitted if all participants are eligible to make contributions and if no employee is permitted to contribute more than 10 percent of compensation, determined based on cumulative contributions and cumulative compensation during the period of participation.

Employer matching contributions are required to satisfy the usual nondiscrimination rules applicable to qualified plans, which prohibit a plan from discriminating in contributions and benefits in favor of employees who are officers, shareholders, or highly compensated. A plan is considered nondiscriminatory if the employer's contributions on behalf of employees are a uniform percentage of compensation. Similarly, a plan is considered nondiscriminatory if the employer's contributions are determined to provide nondiscriminatory retirement benefits. Social security contributions of an employer generally can be taken into account in determining whether contributions constitute a uniform percentage of compensation or nondiscriminatory benefits.

Reasons for Change

The committee is concerned that the rules relating to employer matching contributions and employee contributions under present law encourage employers to shift a greater share of the cost of retirement savings to employees. The committee is also concerned that the present-law nondiscrimination rules permit greater tax-favored contributions by or on behalf of highly compensated employees without comparable participation by rank-and-file employees.

In particular, the committee believes that the present-law nondiscrimination rules for employer matching contributions and employee contributions permit significant tax-favored benefits for highly compensated employees without ensuring that there is comparable saving by rank-and-file employees. The committee believes that a basic reason for extending significant tax incentives to qualified plans is the delivery of comparable benefits to rank-and-file employees who may not otherwise save for retirement. Accordingly, the committee concludes that it is appropriate to revise the nondiscrimination rules for employer matching contributions and employee contributions in order to more closely achieve this goal.

Explanation of Provision

Under the bill, special nondiscrimination rules are applied to employer matching contributions and employee contributions under all qualified defined contribution plans and employee contributions under a defined benefit plan (to the extent allocated to a separate account on behalf of the employee). These nondiscrimination tests apply in lieu of the usual nondiscrimination rules applicable to the amount of contributions under qualified plans.

The committee does not intend, however, that satisfaction of these special nondiscrimination rules will have any effect on the applicability of the usual nondiscrimination rules to aspects of a plan other than the actual amount of employer matching contributions, employee contributions, and elective contributions. Thus, for example, if provisions limiting the amount of employee contributions or elective contributions a participant may make (or limiting the matching contributions the participant may receive) favor highly compensated employees, the plan is discriminatory under the usual nondiscrimination rules.

Employer matching and employee contributions

Under the first test, a defined contribution plan (and the employee contribution portion of a defined benefit pension plan) will not be treated as meeting the special nondiscrimination test with respect to employer matching contributions and with respect to employee contributions for a plan year unless the contribution percentage for highly compensated employees does not exceed the greater of (1) 150 percent of the contribution percentage for all other eligible employees, or (2) the lesser of 250 percent of the contribution percentage for all other eligible employees or such percentage plus 3 percentage points.

Under the bill, a matching contribution is defined as (1) any employer contribution made on behalf of an employee on account of an employee's contribution to a plan, and (2) any employer contribution made on behalf of an employee on account of an employee's elective deferrals under a qualified cash or deferred arrangement. Other employer contributions (including nonelective contributions) may be treated like matching contributions if the contributions are (1) nonforfeitable when made, (2) ineligible for withdrawal prior to attainment of age 59-1/2, death, disability, separation from service, sale of a subsidiary, or plan termination, and (3) satisfy the general nondiscrimination rules applicable to such nonelective contribu-

tions. Also, nonelective contributions may not be used under the special nondiscrimination test if, when disregarding such nonelective contributions, other employer contributions favor highly compensated employees in a way that violates the general nondiscrimination rules (sec. 401(a)(4)).

The contribution percentage for a specified group of employees is the average of the ratios (calculated separately for each employee in the group) of the amount of the matching contributions and employee contributions, and, if the employer so elects, qualified nonelective contributions and/or elective deferrals under a qualified cash or deferred arrangement, actually allocated to an employee's account under all plans of an employer for the plan year, to the employee's compensation for the plan year. For purposes of this test, if an employee contribution is required as a condition of participation in the plan, any employee who would be considered a participant if the employee made a contribution to the plan is treated as a participant in the plan on whose behalf no matching contributions are made.

Definition of highly compensated employees

In general.—The bill applies a new uniform definition of highly compensated employee for these nondiscrimination rules. (See the description in number 2, above.) Under the bill, an employee is treated as highly compensated with respect to a year if, at any time during the year or the preceding year, the employee (1) was a 5-percent owner of the employer (as defined in sec. 416(i)); (2) earned at least $100,000 in annual compensation from the employer; (3) earned at least $50,000 in annual compensation from the employer and was a member of the top-paid group of the employer during the same year; or (4) was an officer of the employer (as defined in sec. 416(i)).

Aggregation rules for employer matching and employee contributions

The bill applies rules similar to the aggregation rules for qualified cash or deferred arrangements for purposes of the special nondiscrimination test for employer matching and employee contributions. Thus, under the bill, if a highly compensated employee participates in more than one plan, all employer matching contributions, employee contributions, elective contributions, and, if the employer so elects, qualified nonelective contributions and/or with respect to that highly compensated employee are aggregated and a single deferral percentage is computed for purposes of applying the special nondiscrimination test under each plan in which the highly compensated employee participates. Of course, the employer could elect to aggregate plans with respect to all participating employees, rather than merely highly compensated employees, in testing whether the special nondiscrimination test is satisfied.

For example, if a highly compensated employee elects to make employee contributions of 5 percent of pay under one plan of an employer and 10 percent of pay under another plan, the employee's contribution percentage is treated as 15 percent for purposes of applying the special nondiscrimination test under each plan.

In addition, if a plan subject to the special nondiscrimination test is combined with another plan, also subject to the special test, for purposes of satisfying the coverage requirements of section 410(b) or the general nondiscrimination requirements of section 401(a)(4), then such plans must be aggregated for purposes of applying the special nondiscrimination test for employer matching and employee contributions.

Treatment of excess contributions

If the special nondiscrimination rules are not satisfied for any year, the bill provides that the plan will not be disqualified if the excess contributions (plus income allocable to such excess contributions) are distributed before the close of the following plan year. Distribution of excess contributions may be made notwithstanding any other provision of the law, and the amount distributed is not subject to the additional income tax on early withdrawals.

Excess contributions means, with respect to any plan year, the excess of the aggregate amount of employer matching contributions and employee contributions (and, if the employer so elects, nonelective contributions and elective contributions) allocated to the accounts of highly compensated employees over the maximum amount of employer matching contributions (and employee contributions) that could be allocated to the accounts of highly compensated employees without violating the special nondiscrimination requirements. To determine the amount of the excess contributions and the employees to whom the excess contributions are to be distributed, the bill provides that the contributions made by or on behalf of highly compensated employees will be reduced in the order of their contribution percentages beginning with those highly compensated employees with the highest contribution percentages.

The excess contributions are to be distributed to those highly compensated employees for whom a reduction is made under the preceding sentence in order to satisfy the special nondiscrimination tests. The bill also provides a special rule for excess contributions that consist of nonvested employer contributions. Such contributions are to be forfeited, rather than distributed. Any excess contributions that are forfeited must be used to reduce employer contributions, or, if reallocated, must be reallocated to participants other that those highly compensated employees who were determined to have excess contributions. Excess contributions are treated as forfeitable if they represent the unvested account balance of a participant who has separated from service, but who has not incurred 5 consecutive one-year breaks in service.

The committee intends that an employer may elect to treat excess contributions as attributable to employee contributions or to both employee and employer matching contributions. However, if employee contributions are reduced, a proportionate reduction in employer matching contributions is required.

Excise tax on excess contributions

Under the bill, an excise tax is imposed on the employer (sec. 4979). The tax is equal to 10 percent of the excess contributions (including excess contributions to a SEP and a sec. 501(c)(18) plan)

under the arrangement for the plan year ending in the taxable year.

However, the total excess contributions do not include any excess contributions that, together with income allocable to the excess contributions, are distributed (or, if nonvested, forfeited) no later than 2-1/2 months after the close of the plan year in which the excess contributions arose.

All excess contributions (plus income) and income on excess employee contributions distributed within the applicable 2-1/2 month period are to be treated as received and earned by the employee in the employee's taxable year to which the contributions relate.

Matching contributions are deemed to relate to the same taxable year to which the employee's mandatory contribution relates, i.e., mandatory contributions that are elective deferrals relate to the taxable year in which the employee would have received (but for the deferral election) the deferral as cash, and mandatory contributions that are employee contributions relate to the taxable year of contribution. Qualified nonelective contributions relate to the taxable year in which or with which the plan year ends. For purposes of this rule, the first matching and employee contributions are deemed to be excess contributions.

Effective Dates

The provisions relating to employer matching contributions and employee contributions generally are effective for plan years beginning after December 31, 1988.

A special effective date applies to plans maintained pursuant to a collective bargaining agreement. Under this special rule, in the case of a plan maintained pursuant to a collective bargaining agreement between employee representatives and one or more employers ratified before March 1, 1986, the amendments are not effective for plan years beginning before the earlier of (1) the later of (i) January 1, 1989, or (ii) the date on which the last of the collective bargaining agreements terminates, or (2) January 1, 1991. Extensions or renegotiations of the collective bargaining agreement, if ratified after February 28, 1986, are disregarded.

4. Unfunded Deferred Compensation Arrangements of State and Local Governments (sec. 1207 of the bill and sec. 457 of the Code)

Present Law

Under an eligible unfunded deferred compensation plan of a State or local government, an employee who defers the receipt of current compensation is required to include the amounts deferred in gross income when they are paid or made available. The maximum annual deferral under such a plan is the lesser of (1) $7,500, or (2) 33-1/3 percent of compensation (net of the deferral). Amounts contributed to a tax-sheltered annuity are taken into account in calculating whether an employee's deferrals exceed the limits.

In general, amounts deferred under an eligible deferred compensation plan may not be made available to an employee before separation from service with the employer. In addition, distributions

under the plan are required to commence no later than 60 days after the close of the later of (1) the year in which the employee attains the normal retirement age under the plan, or (2) the year in which the employee separates from service. Amounts that are made available to an employee upon separation from service are includible in gross income in the taxable year in which they are made available.

Under an eligible deferred compensation plan, distributions must be made primarily for the benefit of participants, rather than beneficiaries. If a participant's benefits commence prior to death, the total amount of payments scheduled to be made to the participant must be more than 50 percent of the maximum amount that could have been paid to the participant if no provision were made for payments to the beneficiary. This rule differs from the incidental benefit rule applicable to qualified plans under which the value of benefits payable during a participant's lifetime must be projected to exceed 50 percent of the total value of benefits payable with respect to the participant.

Under an eligible plan, if a participant dies before the date the entire amount deferred has been paid out, the entire amount deferred (or the remaining portion thereof, if payment commenced before death) must be paid to the participant's beneficiary over a period not exceeding 15 years, unless the beneficiary is the participant's surviving spouse. If the beneficiary is the participant's surviving spouse, benefits must be paid over the life of the surviving spouse or any shorter period.

Deferrals under any plan, agreement, or arrangement with the State that is not an eligible deferred compensation plan (other than a qualified State judicial plan, a qualified plan, or a tax-sheltered annuity) are includible in an employee's gross income when the amounts are not subject to a substantial risk of forfeiture, regardless of whether constructive receipt has taken place.

Reasons for Change

The committee is concerned that the present-law rules relating to the distribution of benefits under an eligible unfunded deferred compensation plan of a State or local government permit deferred compensation under such an arrangement to accumulate on a tax-favored basis for a longer period than is permitted under a qualified plan. Accordingly, the committee believes that more restrictive distribution rules should be imposed on unfunded deferred compensation plans to ensure that tax-favored savings are used primarily for retirement purposes.

Explanation of Provisions

Overview

The bill (1) requires that amounts deferred on a before-tax basis by an employee under a simplified employee plan (SEP) or a qualified cash or deferred arrangement (sec. 401(k)) that is grandfathered under the bill be taken into account in determining whether the employee's deferrals under an eligible deferred compensation plan exceed the limits on deferrals under the eligible plan; (2)

modifies the distribution requirements applicable to eligible deferred compensation plans; (3) permits rollovers between eligible deferred compensation plans; and (4) modifies the rule that an employee is taxable on deferrals under an eligible plan when such amounts are made available.

Offset for deferrals under qualified cash or deferred arrangement

Under the bill, the limits on the amount that a participant may defer under an eligible deferred compensation plan are reduced, dollar for dollar, by a participant's elective deferrals under a qualified cash or deferred arrangement (except a qualified cash or deferred arrangement maintained by a rural electric cooperative).

The bill also provides that an employee's elective deferrals under a SEP and an employee's deductible contributions under a plan that is exempt from tax under section 501(c)(18) reduce, dollar for dollar, the amount that the employee may defer under an eligible deferred compensation plan. In addition, as under present law, all amounts contributed to a tax-sheltered annuity on behalf of an employee are taken into account in calculating whether the employee's deferrals under an eligible unfunded deferred compensation plan exceed the limits on such deferrals.

Minimum distribution requirements

The bill modifies the distribution requirements for eligible deferred compensation plans maintained by State and local governments. As modified, distributions commencing prior to the death of a participant under an eligible deferred compensation plan are required to satisfy a payout schedule under which benefits projected to be paid over the lifetime of the participant are at least 66-2/3 percent of the total benefits payable with respect to the participant.

Under the bill, if the participant dies prior to the date the entire interest has been distributed, or if the participant dies prior to commencement of the distribution of benefits, the bill requires that (1) payments to the participant's beneficiary are to commence within 60 days after the close of the plan year in which the participant's death occurs, and (2) the entire amount deferred is to be distributed over a period not in excess of 15 years.

The bill requires immediate distributions or distributions under the 5-year schedule, unless the beneficiary is the participant's surviving spouse. If the beneficiary is the participant's surviving spouse, payments must be made over the life of the surviving spouse or any shorter period.

Whenever distributions (pre- or post-death) are to be made over a period extending beyond one year, the bill requires that the distribution be made in substantially nonincreasing periodic payments not less frequently than annually.

Constructive receipt

The bill provides that benefits are not treated as made available under an eligible deferred compensation plan merely because an employee is allowed to elect to receive a lump-sum payment within 60 days of the election. However, the 60-day rule only applies if the

employee's total deferred benefit does not exceed $3,500 and no additional amounts may be deferred with respect to the employee.

Rollovers

The bill also amends present law to permit the rollover of benefits between eligible deferred compensation plans under certain circumstances. If the entire amount payable to an employee under an eligible deferred compensation plan is distributed to the employee within one taxable year, the employee is not required to include in income any portion of the distribution transferred by the employee to another eligible deferred compensation plan within 60 days of the date of receipt of the distribution. The committee intends that an individual may make only one rollover per year, and that an individual may not, in any event, roll over an amount that is required to be distributed under the minimum distribution requirements applicable to eligible deferred compensation plans.

State judicial plans

The bill exempts from the new requirements for eligible deferred compensation plans any qualified State judicial plan (as defined in sec. 131(c)(3)(B) of the Revenue Act of 1978, as amended by sec. 252 of the Tax Equity and Fiscal Responsibility Act of 1982).

Effective Date

The provisions are effective for taxable years beginning after December 31, 1988.

5. Deferred Annuity Contracts (sec. 1234 of the bill and sec. 72(u) of the Code)

Present Law

Under present law, income credited to a deferred annuity contract is not currently includible in the gross income of the owner of the contract nor is the income taxed to the insurance company issuing the contract. In general, amounts received by the owner of an annuity contract before the annuity starting date (including loans under or secured by the contract) are includible in gross income as ordinary income to the extent that the cash value of the contract exceeds the owner's investment in the contract. A portion of each distribution received after the annuity starting date is treated as ordinary income based on the ratio of the investment in the contract to the total distributions expected to be received.

A deferred annuity is an annuity contract under which the periodic payments begin, if at all, only after a specified period elapses after purchase of the contract. A deferred annuity has two phases: an accumulation phase and a payout phase. In contrast, an immediate annuity only has a payout phase.

Under present law, deferred annuities are often purchased by individuals in order to save for retirement. In addition, deferred annuities are often purchased by employers in order to fund the employer's obligation to provide nonqualified deferred compensation to its employees. Deferred annuities may also be used to fund bene-

fits provided under qualified pension, profit-sharing, or stock bonus plans.

Present law provides an additional income tax on certain early withdrawals under an annuity contract. Under present law, amounts withdrawn from an annuity contract before the owner of the contract attains age 59-1/2 are subject to an additional income tax equal to 5 percent of the amount of the withdrawal includible in income. This additional tax is not imposed if the distribution is (a) one of a series of substantially equal periodic payments made for the life of the taxpayer or over a period extending for at least 60 months after the annuity starting date, or (b) is allocable to investment in the contract before August 14, 1982.

Distributions under an annuity contract that is held by a qualified plan or that constitutes a tax-sheltered annuity, are not subject to the tax on premature withdrawals under present law.

Reasons for Change

The committee believes that the present-law rules relating to deferred annuity contracts present an opportunity for employers to fund, on a tax-favored basis, significant amounts of deferred compensation for employees. This favorable tax treatment may create a disincentive for employers to provide benefits to employees under qualified pension plans, which are subject to significantly greater restrictions. In addition, because deferred annuity contracts can be provided to a limited class of employees, rather than to employees generally (as is required in the case of a qualified pension plan), the committee is concerned that the present-law treatment of deferred annuity contracts dilutes the effect of the nondiscrimination rules applicable to qualified pension plans.

Further, the committee generally believes that tax incentives for savings should not be provided unless the savings are held for retirement. Thus, the committee believes it appropriate to limit the exception to the early withdrawal tax to distributions in the form of substantially equal payments over the life of the participant.

Explanation of Provision

Income on the contract.—Under the bill, if any annuity contract is held by a person who is not a natural person (e.g., a corporation or a trust is not a natural person), then the contract is not treated as an annuity contract for Federal income tax purposes and the income on the contract for any taxable year is treated as ordinary income received or accrued by the owner of the contract during the taxable year.

Under the bill, in the case of a contract the nominal owner of which is a person who is not a natural person (e.g., a corporation or a trust), but the beneficial owner of which is a natural person, the contract generally is treated as held by a natural person. Thus, if a group annuity contract is held by a corporation as an agent for natural persons who are the beneficial owners of the contract, the contract is treated as an annuity contract for Federal income tax purposes. However, the committee intends that, if an employer is the nominal owner of an annuity contract, the beneficial owners of which are employees, the contract will be treated as held by the

employer. The committee intends this rule because it is concerned that the Internal Revenue Service would have difficulty monitoring compliance with the general rule that a deferred annuity is not available on a tax-favored basis to fund nonqualified deferred compensation.

Income on the contract means the excess of (1) the sum of the net surrender value of the contract at the end of the taxable year and any amounts distributed under the contract for all years, over (2) the investment in the contract, i.e., the aggregate amount of premiums paid under the contract minus policyholder dividends or the aggregate amounts received under the contract that have not been included in income. The Secretary is authorized to substitute fair market value for net surrender value in appropriate cases, if necessary, to prevent avoidance of the otherwise required income inclusion.

The provision does not apply to any annuity contract that is acquired by the estate of a decedent by reason of the death of the decedent, is held under a qualified plan (sec. 401(a) or 403(a)), as a tax-sheltered annuity (sec. 403(b)), or under an IRA.

Early withdrawal tax.—In addition, the bill modifies the circumstances under which the additional income tax on early withdrawals from deferred annuity contracts will be imposed. In the case of a withdrawal from a deferred annuity contract before the owner attains age 59-1/2, dies, or becomes disabled, the 5-percent additional income tax applies unless the distribution is part of a series of substantially equal periodic payments over the life of the owner or over the lives of the owner and a beneficiary. The tax applies regardless of whether the distribution is allocable to investment on the contract before August 14, 1982.

In the event an individual commences receiving distributions prior to attaining age 59-1/2 in a form that is exempt from the additional income tax, if the payment of the individual's benefits is later changed (before the individual attains age 59-1/2) to a form that does not satisfy the conditions for the exemption, the bill authorizes the Secretary of the Treasury to impose the 5-percent excise tax on all distributions under the contract received by the individual prior to age 59-1/2.

If an annuity contract is held by a non-natural person (other than a natural person or a qualified plan), there will be no additional tax imposed on an early withdrawal because there has been no tax benefit attributable to deferral of tax on the income on the contract.

As under present law, distributions under an annuity contract that constitutes a tax-sheltered annuity are not subject to a tax on premature withdrawals. Distributions under an annuity contract that is held by a qualified plan are subject to the additional income tax on premature withdrawals from a qualified plan, discussed at Part C, below.

Effective Dates

The provision of the bill relating to the taxation of income on a deferred annuity contract is effective for amounts invested after February 28, 1986. The provision of the bill modifying the addition-

al income tax on early withdrawals is effective for distributions in taxable years beginning after December 31, 1986. An exception to the provision that modifies the additional income tax on early withdrawals is provided for individuals who, as of March 1, 1986, have commenced receiving benefits under the contract pursuant to a written election designating a specific schedule of benefit payments. The committee intends that this exception will be available if (1) the annuity contract provides for only one form of distribution or (2) the contract provides that, in the absence of an election to the contrary, an individual will be paid benefits according to the automatic form of payment specified in the contract and the individual is, in fact, receiving benefits in that form. Further, the committee intends that, if the exception applies to an individual, the rules of present law apply to the amounts received. Therefore, if benefits paid would be subject to the 5-percent additional income tax under present law, that tax will apply to the benefits paid under the exception.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $3 million in 1987, $13 million in 1988, $31 million in 1989, $48 million in 1990, and $65 million in 1991.

6. Special Rules for Simplified Employee Pensions (sec. 1208 of the bill and sec. 408(k) of the Code)

Present Law

Under present law, if an IRA qualifies as a simplified employee pension (SEP), the annual IRA deduction limit is increased to the lesser of $30,000 or 15 percent of compensation. The increased deduction limit applies only to employer contributions made on behalf of an employee to the SEP.

Present law provides that an IRA does not qualify as a SEP unless employer contributions are made on a nondiscriminatory basis on behalf of each employee who (1) has attained age 25, and (2) has performed services for the employer during at least three of the immediately preceding five calendar years. Under present law, employees are not permitted to make elective deferrals or employee contributions to a SEP.

An IRA qualifies as a SEP for a calendar year if certain requirements relating to employee withdrawals and the employer contribution allocation formula are met. The allocation rules are designed to insure that employer contributions are made on a basis that does not discriminate in favor of employees who are officers, shareholders, or highly compensated.

Under present law, a SEP is not qualified unless the employer contributions are nondiscriminatory without taking into account the employer's contributions on behalf of employees to social security. However, if the employer does not maintain any other integrated plan, then the employer's contributions (OASDI contributions) on behalf of an employee to social security may be taken into account as contributions by the employer to the SEP, but only if

such contributions are taken into account with respect to each employee maintaining a SEP.

Present law provides that an integrated plan is a plan that would not meet the qualification requirements if social security contributions were not taken into account.

Reasons for Change

The committee recognizes that small employers often fail to establish pension plans for employees because of the administrative costs and burdens attributable to such plans. Even the generous tax incentives under present law have not significantly improved pension coverage for employees of small businesses.

The committee believes that simplified employee pensions provide a low-cost retirement savings option to employers that should be encouraged. Therefore, the committee bill adopts miscellaneous SEP changes designed to further simplify the administration of SEPs and to add a special elective deferral feature available only to small employers.

Explanation of Provisions

In general

The bill revises the qualification requirements relating to SEPs to permit employees to elect to have SEP contributions made on their behalf or to receive the contributions in cash. In addition, the bill makes miscellaneous changes to the SEP requirements to decrease the administrative burden of maintaining a SEP.

Salary reduction SEPs

Under the bill, employees who participate in a SEP would be permitted to elect to have contributions made to the SEP or to receive the contributions in cash. If an employee elects to have contributions made on the employee's behalf to the SEP, the contribution is not treated as having been distributed or made available to the employee. In addition, the contribution is not treated as an employee contribution merely because the SEP provides the employee with such an election. Therefore, under the bill, an employee is not required to include in income currently the amounts an employee elects to have contributed to the SEP. Elective deferrals under a SEP are to be treated like elective deferrals under a qualified cash or deferred arrangement and, thus, are subject to the $7,000 (indexed) cap on elective deferrals.

Consistent with the rules applicable to elective deferrals under a qualified cash or deferred arrangement or tax-sheltered annuity under present law, elective deferrals under a SEP are not excludable from the definition of wages for employment tax purposes.

The bill provides that the election to have amounts contributed to a SEP or received in cash is available only if at least 50 percent of the employees of the employer elect to have amounts contributed to the SEP and is available only in a taxable year in which the employer maintaining the SEP has 25 or fewer employees as of the beginning of the year.

In addition, under the bill, the amount eligible to be deferred as a percentage of each highly compensated employee's compensation (i.e., the deferral percentage) is limited by the average deferral percentage (based solely on elective deferrals) for all other employees (other than highly compensated employees) who participate. The deferral percentage for each highly compensated employee cannot exceed the deferral percentage for all other participating employees by more than 150 percent. Of course, integration under section 401(l) is not permitted in applying this 150-percent test. Also, nonelective SEP contributions may not be combined with the elective SEP deferrals for purposes of this test. Finally, an employer may not make matching SEP contributions conditioned on elective SEP deferrals.

Under the bill, the definition of a highly compensated employee is the same definition applied for purposes of the special nondiscrimination test applicable to qualified cash or deferred arrangements (see the description in number 2, above).

For purposes of determining the deferral percentages, an employee's compensation is the amount of the employee's compensation taken into account under the SEP for purposes of calculating the contribution that may be made on the employee's behalf for the year.

If the 150-percent test is not satisfied, rules similar to the rules applicable to excess contributions to a cash or deferred arrangement shall apply.

SEP deduction converted to exclusion from income

Under the bill, the amounts contributed to a SEP by an employer on behalf of an employee and the elective deferrals under a SEP are excludable from gross income, rather than deductible as under present law.

In addition, the bill (1) modifies the rules relating to maintaining a SEP on a calendar year basis, and (2) prescribes rules for maintaining a SEP on a taxable year basis. In the case of a SEP maintained on a calendar year basis, contributions made in a calendar year are deductible for the taxable year with which or within which the calendar year ends, and the contributions are treated as made on the last day of the calendar year if the contributions are made by the due date (plus extensions) of the employer's tax return.

In the case of a SEP maintained on a taxable year basis, contributions are deductible for the taxable year and contributions are treated as made on the last day of the taxable year if the contributions are made by the due date of the employer's tax return for the taxable year, plus any extensions of the due date to which the employer is entitled.

Participation requirements

Under the bill, the participation requirements for SEPs are modified to require that an employer make contributions for a year on behalf of each employee who (1) has attained age 21,[3] (2) has

[3] Age 25 is reduced to age 21 under the provisions of the bill making technical corrections to the Retirement Equity Act of 1984.

performed services for the employer during at least 3 of the immediately preceding 5 years, and (3) received at least $300 in compensation from the employer for the year. Thus, the bill adds a de minimis exception to the requirement that contributions must be made on behalf of all employees. In addition, the bill provides that this 100-percent participation requirement applies separately to elective arrangements and, for purposes of such elective arrangements, an individual who is eligible is deemed to receive an employer contribution. If nonelective SEP contributions are made for any employee, nonelective contributions must be made for all employees satisfying the participation requirements. Similarly, if any employee is eligible to make elective SEP deferrals, all employees satisfying the participation requirements must be eligible to make elective SEP deferrals.

Wage-based contribution limitation for SEPs

Under the bill, the $200,000 limit on compensation taken into account and the $300 de minimis threshold would be indexed at the same time and in the same manner as the dollar limits on benefits under a defined benefit pension plan (sec. 415(d)). As a result, these amounts will be indexed by reference to percentage changes in the social security taxable wage base.

Definition of computation period

The bill permits an employer to elect to use a computation period other than the calendar year for purposes of determining contributions to a SEP. Under the bill, a permissible computation period (other than a calendar year) will include an employer's taxable year, subject to any terms and conditions that the Secretary of the Treasury may prescribe.

Integration rules

The bill eliminates the current rules under which nonelective SEP contributions may be combined with employer OASDI contributions for purposes of the applicable nondiscrimination. In place of these rules, the bill permits nonelective SEP contributions to be tested for nondiscrimination under the new rules for qualified defined contribution plans permitting a limited disparity between the contribution percentages applicable to compensation below and compensation above the social security wage base.

Effective Date

The provisions are effective for years beginning after December 31, 1986.

Revenue Effect

The provision is estimated to decrease fiscal year budget receipts by $15 million in 1987, $29 million in 1988, $28 million in 1989, $33 million in 1990, and $37 million in 1991.

7. Salary Reduction Permitted under Section 501(c)(18) Plans (sec. 1209 of the bill and secs. 219 and 501(c)(18) of the Code)

Present Law

Under present law, a trust or trusts created before June 25, 1959, forming part of a pension plan funded solely by contributions of employees is entitled to tax-exempt status under section 501(a) of the Code (sec. 501(c)(18)). This tax exemption is available if the following requirements are satisfied:

(1) under the plan, it is impossible, at any time prior to the satisfaction of all liabilities with respect to employees under the plan, for any part of the corpus or income to be used for, or diverted to, any purpose other than the providing of benefits under the plan;

(2) the benefits under the plan are payable to employees under a classification set forth in the plan that does not discriminate in favor of officers, shareholders, supervisors, or highly compensated employees; and

(3) the benefits provided under the plan do not discriminate in favor of officers, shareholders, supervisors, or highly compensated employees.

Under the third requirement, a plan is not considered discriminatory merely because the benefits provided under the plan bear a uniform relationship to the total compensation, or the basic or regular rate of compensation, of the employees covered under the plan.

Rev. Rul. 54-190, 1954-1 C.B. 46, concluded that contributions to a pension plan described above were deductible as union dues by an employee making such contributions. In 1982, the Internal Revenue Service declared Rev. Rul. 54-190 obsolete.[4]

Reasons for Change

The committee is concerned that the historical treatment of contributions under a section 501(c)(18) pension plan has been disrupted by the Internal Revenue Service. While the committee believes that the characterization of such pension contributions as union dues is inappropriate and fails to recognize the true nature of the contribution, the committee finds it necessary to provide a mechanism to allow deductions, within limits, for contributions to such plans.

However, the committee believes that employees should not be permitted to contribute to these pension plans on a deductible basis unless the plan meets requirements similar to the rules provided with respect to qualified cash or deferred arrangements, including the limits on annual elective deferrals and the special nondiscrimination rules applicable to such arrangements.

Explanation of Provision

Under the bill, employees who participate in a section 501(c)(18) pension plan are permitted to elect to make deductible contributions if certain requirements are met. If an employee elects to have

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[4] Rev. Rul. 82-127, 1982-1 C.B. 215.

salary reduction contributions made to the plan, the contribution is deductible up to the lesser of $7,000 or 25 percent of the compensation of the employee includible in income for the taxable year. The amounts contributed to the plan reduce the $7,000 annual cap on elective deferrals under qualified cash or deferred arrangements and SEPs.

The bill provides that the election to make deductible contributions to a section 501(c)(18) plan is available only if the plan satisfies a special nondiscrimination test similar to the test applicable to a qualified cash or deferred arrangement. If the test is not satisfied, rules similar to the rules applicable to excess contributions under a qualified cash or deferred arrangement are to apply.

Effective Date

The provision is effective for contributions made in taxable years beginning after December 31, 1986.

Revenue Effect

The provision is estimated to decrease fiscal year budget receipts by less than $5 million annually.

B. Nondiscrimination Requirements

1. Minimum Coverage Requirements for Qualified Plans (secs. 1212, 1214, and 1215 of the bill and secs. 401, 410, and 414(q) of the Code)

Present Law

Under present law, a qualified plan is required to cover employees in general rather than merely the employees of an employer who are officers, shareholders, or highly compensated. A plan generally satisfies the present-law coverage rule if (1) it benefits a significant percentage of the employer's workforce (percentage test), or (2) it benefits a classification of employees determined by the Secretary of the Treasury not to discriminate in favor of employees who are officers, shareholders, or highly compensated (classification test).

Percentage test

A plan meets the percentage test if (1) it benefits at least 70 percent of all employees, or (2) it benefits at least 80 percent of the employees eligible to benefit under the plan and at least 70 percent of all employees are eligible (i.e., the plan benefits at least 56 percent of all employees).

Classification test

A plan meets the classification test if the Secretary of the Treasury determines that it covers a classification of employees that does not discriminate in favor of employees who are officers, shareholders, or highly compensated (highly compensated employees). For purposes of this rule, all active employees (including employees who do not satisfy the minimum age or service requirement of the plan) are taken into account.[1]

Under Treasury regulations,[2] the determination as to whether a classification discriminates in favor of highly compensated employees is to be made on the basis of the surrounding facts and circumstances of each case, allowing for a reasonable difference between the ratio of highly compensated employees who are benefited by the plan to all such employees and the corresponding ratio calculated for employees who are not highly compensated.

The regulation also provides that a showing that a specified percentage of participants in a plan are not highly compensated is not sufficient to establish that the plan does not discriminate in favor of highly compensated employees.

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[1] Treas. Reg. sec. 1.410(b)-1(b)(2).

[2] Treas. reg. sec. 410(b)-1(d)(2), issued by the Treasury in 1980.

In the preamble to this regulation,[3] the Secretary of the Treasury indicated that the regulation would be interpreted in a manner consistent with previously published rulings interpreting and applying the classification test, such as Rev. Rul. 70-200.[4] In Rev. Rul. 70-200, a plan that covered 100 percent of all employees earning over $25,000 and only 25 percent of those earning less than $25,000, was found to be qualified notwithstanding the large disparity in the percentages of high and low paid employees covered by the plan. In Rev. Rul. 83-58,[5] which superseded 70-200, a plan with a similar disparity in the coverage percentages of high and low paid employees was found to be qualified.

Nondiscriminatory contributions or benefits

Additional tests are applied to determine whether contributions or benefits under the plan discriminate in favor of highly compensated employees (sec. 401(a)(4)). The present-law nondiscrimination requirements are satisfied if either the contributions or the benefits under a qualified plan do not discriminate in favor of highly compensated employees (sec. 401(a)(4)).

In applying the nondiscrimination test to benefits under a plan, the rate at which benefits are provided by the plan for highly compensated employees (as a percentage of their compensation) generally is compared with the rate at which benefits are provided for other participants. A similar test may be applied to employer contributions (rather than benefits) under a plan. A plan fails the nondiscrimination standard if both benefits and contributions discriminate in favor of highly compensated employees.

Under present law, in determining whether qualified plan benefits, as a percentage of nondeferred compensation, discriminate in favor of employees who are highly compensated, the portion of each employee's social security benefits paid for by the employer may be taken into account. For this purpose, social security benefits mean Old Age, Survivors, and Disability Insurance (OASDI) benefits provided under the Social Security Act. Section 401(l) and Revenue Rulings 71-446[6] and 83-110[7] provide guidance for taking social security contributions into account.[8]

A plan does not satisfy the nondiscrimination requirements if, by any device, it discriminates either in eligibility requirements, contributions, or benefits in favor of highly compensated employees.

Aggregation rules

In applying the qualification rules (including the coverage and nondiscrimination tests), all employees of corporations that are members of a controlled group of corporations, or all employees of trades and businesses (whether or not incorporated) that are under common control, are aggregated and treated as if employed by a single employer (sec. 414(b) and (c)). Similarly, all employees of em-

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[3] Treas. Reg. sec. 1.410(b)-1, TD 7735, 45 F.R. 74721.
[4] 1970-1 C.B. 101.
[5] 1983-1 C.B. 95.
[6] 1971-2 C.B. 187.
[7] 1983-2 C.B. 70.
[8] For further discussion of the present-law integration rules and provisions contained in the bill relating to integration, see number 3, below.

ployers that are members of an affiliated service group are treated as employed by a single employer for purposes of the qualification requirements (sec. 414(m)).

In addition, for purposes of certain rules applicable to qualified plans and simplified employee pensions (SEPs), an individual (a leased employee) who performs certain services for another person (the recipient) on a substantially full-time basis for at least 12 months is treated as the recipient's employee if the services are performed because of an agreement between the recipient and a third person (the leasing organization) who is otherwise treated as the individual's employer (sec. 414(n)).

Finally, the Secretary of the Treasury has the regulatory authority to develop any rules as may be necessary to prevent the avoidance of any employee benefit requirement to which the employee leasing or affiliated service group provisions apply through the use of separate organizations, employee leasing, or other arrangements (sec. 414(o)).

Aggregation of plans and comparability

Under present law, an employer may designate two or more plans as a single plan for purposes of satisfying the coverage requirements.[9] However, if several plans are designated as a single plan, the plans, considered as a unit, must be provided for the exclusive benefit of employees and also must provide contributions or benefits that do not discriminate in favor of highly compensated employees.

In determining whether one or more plans designated as a unit provide benefits or contributions that do not discriminate in favor of highly compensated employees, it is necessary to determine whether the designated plans provide "comparable" benefits or contributions. Rev. Rul. 81-202[10] provides guidance that may be applied to determine whether the amount of employer-derived benefits or contributions provided under several plans discriminate in favor of highly compensated employees. The ruling provides methods for imputing the value of employer-provided social security benefits in testing comparability. The value of those social security benefits may be taken into account whether or not the plans are explicitly coordinated with social security.

Excludable employees

In applying the percentage test, certain employees who have not yet completed minimum periods of service (generally one year)[11] and employees who have not yet attained certain minimum ages (generally age 21) may be disregarded if they are excluded pursuant to a plan provision. In addition, in applying the percentage test or the classification test, employees not covered by the plan and included in a unit of employees covered by an agreement that the

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[9] Treas. Reg. sec. 1.410(b)-1(d)(3)(ii) prohibits this designation in certain cases involving TRASOPs and, prior to 1984, certain plans subject to sec. 401(a)(17).

[10] 1981-2 C.B. 93.

[11] Under a special rule, an employee may be excluded from participation for up to 3 years provided the employee is fully and immediately vested in employer-provided benefits after 3 years of service (i.e., if full and immediate vesting is provided upon commencement of plan participation.)

Secretary of Labor finds to be a collective bargaining agreement between employee representatives[12] and one or more employers are disregarded if there is evidence that retirement benefits were the subject of good faith bargaining between such employee representatives and the employer or employers (sec. 410(b)(3)(A)). Certain nonresident aliens and certain airline employees may be disregarded in applying the coverage tests (sec. 410(b)(3)(B) and (C)).

Highly compensated employees

Under present law, an employee who is an officer, shareholder, or highly compensated is considered a highly compensated individual in whose favor discrimination is prohibited. Present law does not further define the term "highly compensated" and, under judicial and administrative precedent, the level of compensation that makes an employee highly compensated depends on the facts and circumstances of each case.

Reasons for Change

For many years, the committee has supported measures that provide tax incentives designed to encourage employers to provide retirement benefits for rank-and-file employees. It has been the committee's intention that these tax incentives, which are more valuable for individuals with high levels of income because of their marginal tax rates, should be available to employers only if their plans provide benefits for rank-and-file employees.

Coverage tests for qualified plans originally were provided by remedial legislation in 1942 to prevent abuses. The committee is now concerned that current interpretations of the coverage tests for qualified plans, by permitting large disparities in the coverage of highly compensated employees and nonhighly compensated employees, are not sufficient to ensure broad, nondiscriminatory coverage of rank-and-file employees. The coverage rules provided by the bill are intended by the committee to deny tax benefits to plans in which the percentage of highly compensated employees who benefit under a plan is unreasonably in excess of the percentage of other employees benefiting under the plan.

The committee believes that Rev. Rul. 83-58 and similar interpretations of the coverage tests have permitted employers to obtain the tax benefits accorded to highly compensated participants in qualified plans without providing similar benefits to a comparable percentage of rank-and-file employees. The committee believes that no more than a reasonable disparity should be permitted in the percentage of highly compensated employees covered and the percentage of nonhighly compensated employees covered by a qualified plan. The committee recognizes that what constitutes a reasonable disparity will vary with the facts and circumstances of a particular case, including the existence of separate lines of business or operating units. In order to give employers more certainty in the application of the bill, the committee concludes that a safe-harbor

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[12] An organization is not considered to be an employee representative if more than one-half of its members participating in the plan are employees who are also owners, officers, or executives of the employer. Sec. 7701(a)(46).

rule for determining a separate line of business or operating unit is appropriate.

The committee also believes that the present-law definition of the prohibited group in whose favor discrimination is prohibited is imprecise and difficult to administer. The bill provides a uniform, more mechanical definition of highly compensated employees.

Explanation of Provision

Overview

The bill (1) increases, to 80 percent of all employees, the level of coverage necessary to satisfy the "percentage test"; (2) replaces the "classification test" of present law with a "reasonable classification test" and provides the Treasury with guidance as to the manner in which the test is to be interpreted; (3) establishes an alternative method for satisfying the reasonable classification test ("alternative reasonable classification test"); (4) clarifies the circumstances under which an employee will be treated as benefiting under a plan for purposes of the coverage rules; (5) permits, for purposes of satisfying the reasonable classification test, the exclusion from consideration of employees who have not satisfied certain minimum age and service requirements; (6) establishes an objective definition of those employees in whose favor discriminatory coverage is prohibited; (7) permits satisfaction of certain of the coverage rules on a controlled group or line of business basis; (8) establishes a definition of a line of business or separate operating unit with a special safe-harbor rule; and (9) contains a special transition rule for certain dispositions or acquisitions of a business.

General coverage rules

Under the bill, a plan is not qualified unless the plan satisfies either (1) a percentage test, or (2) a reasonable classification test. A plan that does not satisfy the reasonable classification test will be treated as meeting that test if the plan satisfies an alternative reasonable classification test.

Percentage test

A plan meets the percentage test if it benefits 80 percent or more of all employees of the employer.

Reasonable classification tests

The bill replaces the classification test of present law with a new reasonable classification test. Under the bill a plan meets the reasonable classification test if it benefits a reasonable classification of employees that (1) is set up by the employer, and (2) the Secretary of the Treasury finds does not allow more than a reasonable difference (in favor of highly compensated employees) between the coverage percentage of highly compensated employees and the coverage percentage of other employees.

The committee intends that, as under the regulations relating to coverage under present law, the Treasury interpret the reasonable classification test to permit no more than a reasonable disparity between the ratio of the highly compensated employees benefited by a plan to all such employees and the ratio of nonhighly compensat-

ed employees benefited by the plan to all nonhighly compensated employees. To this end, the committee directs the Secretary of the Treasury to revoke Rev. Rul. 83-58, its predecessor rulings, and the preamble to Treas. Reg. sec. 1.410(b)-1 as expressions of the reasonable classification test.

The committee recognizes that what constitutes a "reasonable" disparity will depend on the facts and circumstances of the particular case and directs the Treasury to reissue regulations that take a proportionality approach to coverage, with a list of facts and circumstances that will be considered in determining whether a plan satisfies the reasonable classification test.

Alternative reasonable classification test

In general.—Under the bill, a plan that does not satisfy the reasonable classification test will be treated as meeting the reasonable classification test if (1) the plan satisfies the classification test of section 410(b)(1)(B), as in effect immediately before the enactment of the Tax Reform Act of 1986, and (2) the average benefit percentage ratio of the employer (as that term is defined in the bill) is at least 3/5. This test is referred to herein as the alternative reasonable classification test.

Prior-law classification test.—The reference to "the classification test of section 410(b)(1)(B), as in effect immediately before the enactment of the Tax Reform Act of 1986," is a reference to the test as it has been construed and applied and may be construed and applied in future litigation and rulings. The committee does not intend to freeze the current interpretation of the classification test. In addition, determination letters interpreting the classification test have no precedential value and apply only to the recipient of such letter.

Average benefit percentage ratio.—The term "average benefit percentage ratio" refers to the ratio of the average benefit percentage for employees who are not participants in alternative plans of the employer, to the average benefit percentage for employees who are participants in alternative plans of the employer.

Alternative plan.—The term "alternative plan" refers to any plan that satisfies the requirements of the classification test of section 410(b)(1)(B), as in effect immediately before the enactment of the Tax Reform Act of 1986, and that does not satisfy the new reasonable classification test without regard to the alternative reasonable classification test.

Average benefit percentage.—The term "average benefit percentage" means, with respect to a group of employees, the average of each employee's "benefit percentage." The term "benefit percentage" refers to the employer-provided contributions (including forfeitures) or benefits of an employee under a plan expressed as a percentage of such employee's compensation (as defined under sec. 415). For purposes of computing an employee's benefit percentage under a plan, disparities permitted under the new integration rules may be taken into account.

Employees in more than one plan.—In the case of an employee who receives contributions or benefits under an alternative plan, as well as under a plan that is not an alternative plan, for purposes of calculating the average benefit percentage for any alternative

plans (or plans), only the contributions or benefits provided to the employee under the alternative plan are taken into account. For purposes of calculating the average benefit percentage of the nonalternative plans, generally only the contributions or benefits received by the employee from the nonalternative plan are taken into account. As an exception to this rule, the bill provides that, in the case of a highly compensated employee covered by both an alternative plan and a plan other than an alternative plan, the contributions or benefits received by the employee from plans other than an alternative plan are treated as received by the employee under the alternative plan. A highly compensated employee who is not covered by any plan is treated as covered by an alternative plan, for purposes of computing the average benefit percentage of the alternative plan, and such employee's average benefit percentage is deemed to be zero.

Year of determination.—For purposes of determining whether the alternative reasonable classification test is satisfied in a particular year, each employee's benefit percentage is to be computed, at the election of the employer, on the basis of contributions provided or benefits accrued during (a) that plan year, or (b) a consecutive plan year period (not in excess of 5) ending with the current plan year. The consecutive plan year period chosen by the employer is to be uniformly applied in computing each employee's benefit percentage, and may not be changed without the consent of the Secretary of the Treasury.

Example of the alternative reasonable classification test.—Under the alternative reasonable classification test, if an employer maintains a plan (or plans) that satisfies the present-law classification test, but that does not satisfy the reasonable classification test of the bill, the plan (or plans) will nevertheless be deemed to satisfy the reasonable classification test if those employees who are not covered by the plan (or plans) being tested (other than excludable employees) receive, on average, qualified plan benefits equal to at least 60 percent of the average employer-provided benefit per employee provided under the plan (or plans) being tested.

For example, assume that an employer has 100 employees, 40 of whom are covered by a salaried plan that satisfies the classification test of present law, but does not satisfy the reasonable classification test of the bill. Of the 60 remaining employees, 10 are excludable employees[13] who need not be taken into consideration for purposes of applying the coverage rules. Of the remaining 50, 40 are covered by an hourly plan the average benefit percentage of which is 90 percent of that of the salaried plan (taking into account the extent to which the plan is, or could have been integrated under the provisions of the bill relating to integration).[14] The salaried and hourly plans have no participants in common. In computing the average benefit percentage of the 50 employees who are not covered by the salaried plan, the 10 employees who are not covered by the plan and who are not excludable employees are counted as zeros. As a result, the average benefit percentage of the 50 nonexcludable employees who are not covered by the salaried plan is 72

[13] See, generally, the description of excludable employees, below.

[14] See item B. 3., below, for a discussion of the provisions of the bill relating to integration.

percent. The average benefit percentage for those 50 employees is computed by multiplying the number of employees who are excluded from the salaried plan and who are not excludable employees (40) by the benefit percentage under the plan in which they participate (90 percent), and by dividing the resulting product by the number of employees who are excluded from the tested plan but who are not excludable employees (50). Accordingly, the salaried plan (the tested plan) satisfies the alternative reasonable classification test.

Employees benefiting under the plan

For purposes of the (a) percentage test, (b) the reasonable classification test, and (c) the alternative reasonable classification test, an employee, generally, will be treated as benefiting under the plan only if the employee is a participant in the plan. However, in the case of a cash or deferred arrangement or the portion of a defined contribution plan to which employee contributions and employer matching contributions are made, an employee will be treated as benefiting under the plan if the employee is eligible to make contributions to the plan.

Aggregation of plans and comparability

As under present law, for purposes of applying the percentage test or the reasonable classification test, more than one plan may be designated as a unit and tested as a single entity, if the plans so designated provide benefits that do not discriminate in favor of highly compensated employees. Also, for purposes of satisfying the alternative reasonable classification test, two or more comparable plans may be aggregated for purposes of determining whether the plans together satisfy the classification test of present law.

Under the bill, the comparability analysis contained in Rev. Rul. 81-202 is to be modified to substitute the new integration rules for the integration rules of current law. The committee encourages the Secretary of the Treasury to issue revised and simplified guidelines for comparability analysis.

Excludable employees

For purposes of determining whether a plan (a) benefits 80 percent of all employees, (b) benefits a reasonable classification of employees, or (c) satisfies the alternative reasonable classification test, the bill generally permits the employer to exclude from consideration certain classes of employees.

Minimum age and service.—If a plan (a) prescribes minimum age or service requirements as a condition of participation, and (b) excludes all employees who do not satisfy such requirements, then the employer may disregard such employees in applying the percentage test (as under present law), and in applying the reasonable classification test. For purposes of applying the alternative reasonable classification test, the employer may take into account all employees or, alternatively, may exclude those employees who have not satisfied the minimum age and service requirements that are the lowest such age or service requirement for any plans taken into account in applying the test. The lowest age and service used need not be the age and service requirements under the same plan.

The bill provides that employees who are not excluded from consideration in applying the alternative reasonable classification test because they are covered under a separate plan, but who could have been excluded had the employer used other minimum age or service requirements in such other plan, may be excluded from consideration if the coverage of such employees, tested separately, satisfies the coverage and nondiscrimination rules.

Collective bargaining agreement.—As under present law, for purposes of applying the percentage test and the reasonable classification test to a plan, the employer may exclude from consideration employees not included in the plan who are included in a unit of employees covered by a collective bargaining agreement.

For purposes of the alternative reasonable classification test, all employees included in a unit of employees covered by a collective bargaining agreement are disregarded, regardless of whether any of those individuals are covered by any of the plans being tested, except for purposes of determining whether an alternative plan satisfies the requirements of section 410(b)(1)(B) as in effect immediately before the enactment of the Tax Reform Act of 1986.

Miscellaneous.—As under present law, nonresident aliens with no United States source income may be disregarded for purposes of applying the coverage rules. Similarly, in the case of a collective bargaining agreement covering a unit of airline pilots, employees not covered by the agreement may be disregarded.

Highly compensated employees

The bill provides a new uniform definition of the group of employees in whose favor discrimination is prohibited ("highly compensated employees") that generally applies for purposes of the nondiscrimination rules for qualified plans and statutory employee benefit plans.

An employee is treated as highly compensated with respect to a year if, at any time during the year or the preceding year, the employee (1) was a 5-percent owner of the employer (as defined in sec. 416(i)); (2) earned more than $100,000 in annual compensation from the employer; (3) earned more than $50,000 in annual compensation from the employer and was a member of the top-paid group of employees during the same year; or (4) was an officer of the employer (as defined in sec. 416(i)). The $50,000 and $100,000 thresholds are indexed by reference to the method, as of May 1, 1986, of percentage increases in the social security taxable wage base (i.e., at the same time and in the same manner as the adjustments to the dollar limits on benefits under defined benefit pension plans).

Line of business or operating unit

In general.—As under present law, all employees of corporations that are members of a controlled group of corporations, or all employees of trades or businesses (whether or not incorporated) that are under common control, are aggregated and treated as if employed by a single employer (sec. 414(b) and (c)). Similarly, all employees of employers that are members of an affiliated service group are treated as employed by a single employer for purposes of the qualification requirements (sec. 414(m)).

The bill generally requires that the percentage test, the reasonable classification test, and the alternative reasonable classification test be satisfied on an aggregate basis. However, if an employer establishes to the satisfaction of the Secretary that the employer operates separate lines of business or operating units for bona fide business reasons, a plan maintained by the employer for employees in a line of business or operating unit will not be considered discriminatory if, with respect to the employees in the line of business or operating unit for which the plan is maintained, it satisfies (a) the reasonable classification test, or (b) the alternative reasonable classification test. However, the committee intends that a plan will not be treated as satisfying the reasonable classification test, or the alternative reasonable classification test on a line of business or operating unit basis unless the plan also satisfies the classification test of section 410(b)(1)(B) as in effect immediately before enactment of the Tax Reform Act of 1986.

Safe harbor for separate lines of business or operating units.—The bill provides a safe-harbor rule under which a separate line of business or operating unit is treated as being operated for bona fide business reasons if such line of business or operating unit is a separate self-sustaining unit and if (1) each line of business or operating unit has at least 50 employees who do not perform services for any other line of business or operating unit; and (2) the "highly compensated employee percentage" of the line of business or operating unit is (a) not less than one-half, nor (b) more than twice the percentage of all employees of the employer who are highly compensated. For purposes of this requirement, the highly compensated employee percentage of a line of business or operating unit will be treated as not less than one-half of the percentage of all employees of the employer who are highly compensated if at least 10 percent of all highly compensated employees of the employer are employed by the line of business or operating unit.

Highly compensated employee percentage.—Under the bill, the term "highly compensated employee percentage" means the percentage of all employees performing services for a line of business or operating unit who are highly compensated employees. For purposes of determining the number of employees performing services for a line of business or operating unit, and the highly compensated employees percentage of a line of business or operating unit, the committee intends that the Secretary develop rules governing the circumstances under which an employee will be treated as performing services for a line of business or operating unit.

Impermissible use of a line of business.—The committee intends that the Secretary prescribe by regulation what constitutes a line of business or operating unit. It is the intent of the committee that the line of business or operating unit concept not be used to undermine the nondiscrimination rules. Thus, for example, certain job classifications (such as hourly employees or leased employees) could not be considered separate lines of business or operating units. Also, for example, the committee does not intend that secretaries and other support service personnel be treated as in a line of business or operating unit separate from the lawyers or other professionals for whom such personnel perform services, or that nurses and laboratory personnel be treated as in a line of business sepa-

rate from the medical doctors for whom they perform services. In addition, the bill provides that the members of an affiliated service group (sec. 414(m)) may not be treated as separate lines of business or operating units.

In general, the committee intends that the headquarters (or home office) of an employer is not to be treated as a separate line of business or operating unit. Instead, the Secretary is to prescribe regulations under which headquarters personnel may be considered employed by one line of business or operating unit even though such personnel perform services for other lines of business or operating units.

It is generally intended that a line of business or operating unit include all employees necessary for preparation of certain classes of property for sale or the provision of services to customers. Certain exceptions to this rule may be established by regulation where one employer has two operations which are vertically integrated and which are traditionally operated by unrelated entities.

Combining lines of business.—The committee intends that if a line of business or operating unit would be recognized, but for the fact that it does not satisfy the 50 employee or the highly compensated employee percentage tests, it may be combined with another line of business or operating unit, provided that the aggregate entity satisfies the 50 employee and the highly compensated employee percentage tests. With respect to any plan maintained for employees performing services for one of the combined lines of business, the plan is required to satisfy the coverage rules with respect to the aggregate entity.

Excludable employees.—For purposes of determining the number of employees in a line of business or operating unit and the highly compensated employee percentage of a line of business or operating unit, an employer may disregard the categories of employees that may be disregarded for purposes of determining which employees are highly compensated employees. (See the description in Part A, number 2, above.)

Common plan for more than one line of business.—The bill provides that if employees of more than one line of business or operating unit are eligible to participate in a single plan, then all such lines of business or operating units shall be treated as one line of business or operating unit.

Special rules for certain dispositions and acquisitions

The bill contains special transition rules for certain dispositions or acquisitions of a business. Under the bill, if a person becomes or ceases to be a member of a controlled group or affiliated service group, the coverage rules will be deemed satisfied during the transition period (as defined in the bill), provided that (1) the coverage rules were satisfied immediately before the acquisition or disposition, and (2) the coverage under the plan does not change significantly during the transition period (other than by reason of the acquisition or disposition). The transition period is defined under the bill as the period beginning on the date of the acquisition or disposition and ending on the last day of the first plan year beginning after the transaction.

Effective Date

The provision generally is effective for plan years beginning after December 31, 1988.

A special effective date applies to plans maintained pursuant to a collective bargaining agreement. Under this special rule, in the case of a plan maintained pursuant to a collective bargaining agreement between employee representatives and one or more employers ratified before March 1, 1986, the amendments are not effective for plan years beginning before the earlier of (1) the later of (i) January 1, 1989, or (ii) the date on which the last of the collective bargaining agreements terminates, or (2) January 1, 1991. Extensions or renegotiations of the collective bargaining agreement, if ratified after February 28, 1986, are disregarded.

2. Minimum Participation Rule (sec. 1212(b) of the bill, and new sec. 401(a)(27) of the Code

Present Law

In general

Under present law, an employer may designate two or more plans as a single plan for purposes of satisfying the coverage requirements applicable to qualified plans (sec. 410(b)).[15] However, if several plans are designated as a single plan, the plans, considered as a unit, must be provided for the exclusive benefit of employees and also must provide contributions or benefits that do not discriminate in favor of highly compensated employees (sec. 401(a)(4)).

Comparability

In general.—In determining whether several different plans designated as a unit provide benefits or contributions that do not discriminate in favor of highly compensated employees, it is necessary to determine whether the different plans provide "comparable" benefits or contributions. Rev. Rul. 81-202[16] provides guidance that may be applied to determine whether the amount of employer-derived benefits or contributions provided under several plans discriminate in favor of highly compensated employees. That ruling provides (1) methods to adjust all types of benefits to a standard form; (2) methods to convert benefits into contributions, and contributions into benefits; and (3) methods for imputing the value of employer-provided social security benefits.

The ruling generally provides that the amount of employer-derived benefits provided by a plan or plans will be considered nondiscriminatory if (1) the normalized employer-provided benefits, or (2) both the actual employer contributions and the adjusted contributions do not constitute a greater percentage of nondeferred compensation for any highly compensated employee than for any nonhighly compensated employee. The ruling allows either contributions or benefits to be compared regardless of the type of plans involved.

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[15] See item B., 1, above, for a discussion of the coverage rules applicable to qualified plans.
[16] 981-2 C.B. 93.

Comparability of benefits.—Under Rev. Rul. 81-202, if comparability is to be tested on the basis of benefits, the normalized employer-provided benefit[17] provided for any highly compensated employee must not constitute a greater percentage of nondeferred compensation than for any nonhighly compensated employee.

Comparability of contributions:—Under Rev. Rul. 81-202, if comparability is to be determined on the basis of contributions, neither actual employer contributions nor adjusted employer contributions[18] for any highly compensated employee may constitute a greater percentage of nondeferred compensation than for any nonhighly compensated employee.

Social security integration.—Rev. Rul. 81-202 also includes rules to value employer-provided social security benefits in testing comparability. The value of those social security benefits may be taken into account whether or not the plans are explicitly coordinated with social security.

Disparity in other plan provisions.—Rev. Rul. 81-202 measures only whether the amount of employer-provided benefits or contributions are discriminatory. A plan that provides comparable benefits, within the meaning of that ruling, could still be considered discriminatory if other plan provisions, in form or operation, discriminate in favor of highly compensated employees. For example, a plan which permitted only highly compensated employees to elect to receive a lump-sum distribution has been determined to be discriminatory in Rev. Rul. 85-59.[19]

Reasons for Change

The committee believes that it is inappropriate to permit an employer to maintain multiple plans, each of which covers a very small number of employees. Although plans that are aggregated are required to satisfy the requirements of Rev. Rul. 81-202, such an arrangement may still discriminate in favor of the prohibited group. Differences in the rates at which benefits are accrued (e.g., presence or absence of past service credit) and the selective use of actuarial assumptions in valuing plan benefits, may cause a plan that appears to satisfy the requirement of comparability to favor the highly paid in actuality. Similarly, discrimination in favor of the highly paid is also possible even where plans are comparable, because disparate funding levels and benefit options are not taken into account for purposes of comparability analysis.

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[17] The normalized employer-provided benefit for any individual is the employer-provided portion of the most valuable projected benefit, expressed as the actuarial equivalent amount of plan benefit commencing at age 65, and adjusted to reflect (1) the value of an annuity for the life of the participant commencing at such age with no death benefits and no other ancillary benefits, as well as (2) the difference, if any, in vesting provisions among the plans being considered.

[18] In a defined contribution plan actual employer contributions are the employer contributions allocated to a participant's account, determined without taking forfeitures into account, and adjusted employer contributions are the sum of employer contributions and forfeitures projected to be allocated to a participant's account during the period of participation. In the case of a defined benefit pension plan, actual employer contributions and adjusted employer contributions for any participant are identical—the amount needed to fund the normalized employer-provided benefit over the participant's period of participation (i.e., from the date of initial participation to the latest of age 65, current age, or normal retirement age). In making this calculation, the only actuarial assumptions to be used are reasonable interest and mortality assumptions.

[19] 1985-1 C.B. 95.

Although such arrangements may be vulnerable to challenge as discriminatory under present law, the committee is concerned that because of the large number of these arrangements, the inherent complexity of comparability analysis, and the difficulties in discovering all differences in funding levels and benefit options, the IRS lacks sufficient resources to monitor compliance with the nondiscrimination standards by small aggregated plans. Accordingly, the bill establishes a new "minimum number of participants" rule that must be satisfied by all plans on an individual basis.

Explanation of Provision

Under the bill, a plan is not a qualified plan unless it benefits no fewer than the lesser of (a) 50 employees or (b) 40 percent or more of all employees of the employer. The requirement may not be satisfied by aggregating comparable plans. In the case of a cash or deferred arrangement or the portion of a defined contribution plan to which employee contributions or employer matching contributions are made, an employee will be treated as benefiting under the plan if the employee is eligible to make contributions to the plan.

The bill generally provides that, for purposes of applying the minimum participation rules, the same categories of employees may be disregarded as may be disregarded for purposes of applying the general coverage rules. In the case of a plan covering only employees included in a unit of employees covered by a collective bargaining agreement, all employees not included in such unit may be disregarded for purposes of satisfying the minimum participation rule.

Effective Date

The provisions are generally effective for plan years beginning after December 31, 1988.

A special effective date applies to plans maintained pursuant to a collective bargaining agreement. Under this special rule, in the case of a plan maintained pursuant to a collective bargaining agreement between employee representatives and one or more employers ratified before March 1, 1986, the amendments are not effective for plan years beginning before the earlier of (1) the later of (i) January 1, 1989, or (ii) the date on which the last of the collective bargaining agreements terminates, or (2) January 1, 1991. Extensions or renegotiations of the collective bargaining agreement, if ratified after February 28, 1986, are disregarded.

3. Vesting Standards (sec. 1213 of the bill and sec. 411 of the Code)

Present law

In general

Prior to the enactment of ERISA, a qualified plan was required to provide vested (i.e., nonforfeitable) rights to employees when they attained the normal or stated retirement age. Qualified plans were also required to vest employees upon plan termination or the discontinuance of employer contributions. However, no preretire-

ment vesting was required unless the absence of such vesting caused discrimination in favor of officers, shareholders, supervisors, or highly compensated employees.

To ensure that employees with substantial periods of service with the employer do not lose plan benefits upon separation from employment, the Code generally requires that under a qualified plan (1) a participant's benefits be fully vested upon attainment of normal retirement age under the plan; (2) a participant be fully vested at all times in the benefit derived from employee contributions; and (3) employer-provided benefits vest at least as rapidly as under one of 3 alternative minimum vesting schedules (Code sec. 411(a)). Under these schedules, an employee's right to benefits derived from employer contributions becomes nonforfeitable (vested) to varying degrees upon completion of specified periods of service with an employer.

Under one of the schedules, full vesting is required upon completion of 10 years of service (no vesting is required before the end of the 10th year). Under a second schedule, vesting begins at 25 percent after completion of 5 years of service and increases gradually to 100 percent after completion of 15 years of service. The third schedule takes both age and service into account, but, in any event, requires 50-percent vesting after 10 years of service, and an additional 10-percent vesting for each additional year of service until 100-percent vesting is attained after 15 years of service.

Patterns of discrimination

Prior to ERISA, preretirement vesting was sometimes required under a qualified plan to prevent discrimination. Although ERISA required all plans to meet certain minimum preretirement vesting standards, ERISA also provided that earlier vesting may still be required under a qualified plan to prevent discrimination if (1) there has been a pattern of abuse under the plan tending to discriminate in favor of employees who are officers, shareholders, or highly compensated, or (2) there has been, or there is reason to believe there will be, an accrual of benefits or forfeitures tending to discriminate in favor of employees who are officers, shareholders, or highly compensated (Code sec. 411(d)(1)).

Top-heavy plans

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) required earlier preretirement vesting for certain top-heavy plans to improve the likelihood that covered participants would receive benefits.[20] For any plan year for which a qualified plan is top heavy, an employee's right to accrued benefits must become nonforfeitable under one of 2 alternative schedules. Under the first top-heavy schedule, a participant who has completed at least 3 years of service with the employer maintaining the plan must have a nonforfeitable right to 100 percent of the accrued benefit derived from employer contributions.

A plan satisfies the second alternative (6-year graded vesting) if a participant has a nonforfeitable right to at least 20 percent of the

[20] A top-heavy plan is a qualified plan under which more than 60 percent of the benefits are provided for key employees (Code sec. 416).

accrued benefit derived from employer contributions at the end of 2 years of service, 40 percent at the end of 3 years of service, 60 percent at the end of 4 years of service, 80 percent at the end of 5 years of service, and 100 percent at the end of 6 years of service with the employer.

Class year plans

Special vesting rules also apply to "class year plans." A class year plan is a profit-sharing, money purchase, or stock bonus plan that provides for the separate vesting of employee rights to employer contributions on a year-by-year basis. The minimum vesting requirements are satisfied if the plan provides that a participant's right to amounts derived from employer contributions with respect to any plan year are nonforfeitable not later than the close of the fifth plan year following the plan year for which the contribution was made.

Changes in vesting schedule

Under present law, if a plan's vesting schedule is modified by plan amendment, the plan will not be qualified unless each participant with no less than 5 years of service is permitted to elect within a reasonable period after the adoption of the amendment to have the nonforfeitable percentage of the participant's accrued benefit computed under the plan without regard to the amendment.

Reasons for Change

The committee believes that present law does not meet the needs of many workers who change jobs frequently. In particular, women and minorities are disadvantaged by the present rules because they tend to be more mobile, shorter service employees. In addition, lower-paid employees, in general, are more likely to be mobile and thus more likely to terminate employment before vesting in any accrued benefits. Accordingly, the committee believes that more rapid vesting would enhance the retirement income security of low- and middle-income employees.

In addition, it is arguable that an employee who (directly or indirectly) accepts a reduced current compensation package in exchange for qualified plan benefits should not have receipt of plan benefits made contingent on an overly lengthy deferred vesting schedule. At the same time, the committee believes that some deferral of vesting is appropriate to preclude the vesting of very short-service or transient workers. Accordingly, the bill provides for more rapid vesting than that permissible under present law, but does not require immediate vesting.

Explanation of Provision

In general

The bill provides that a plan is not a qualified plan (except in the case of a multiemployer plan), unless a participant's employer-provided benefit vest at least as rapidly as under one of 2 alternative minimum vesting schedules.

A plan satisfies the first schedule if a participant has a nonforfeitable right to 100 percent of the participant's accrued benefit derived from employer contributions upon the participant's completion of 5 years of service. A plan satisfies the second alternative schedule if a participant has a nonforfeitable right to at least 20 percent of the participant's accrued benefit derived from employer contributions after 3 years of service, 40 percent at the end of 4 years of service, 60 percent at the end of 5 years of service, 80 percent at the end of 6 years of service, and 100 percent at the end of 7 years of service.

Top-heavy plans

The provisions of the bill relating to vesting do not alter the requirements applicable to plans that become top heavy. Thus, a plan that becomes top heavy is required to satisfy one of the two alternative vesting schedules applicable under present law to top-heavy plans.

Class year plans

Under the bill, a plan with class year vesting will not meet the qualification standards of the Code unless, under the plan's vesting schedule, a participant's total accrued benefit becomes nonforfeitable at least as rapidly as under one of the two alternative vesting schedules specified in the bill.

Changes in vesting schedule

Under the bill, if a plan's vesting schedule is modified by plan amendment, the plan will not be qualified unless each participant with no less than 3 years of service is permitted to elect, within a reasonable period after the adoption of the amendment, to have the nonforfeitable percentage of the participant's accrued benefit computed without regard to the amendment.

Multiemployer plans

As an exception to the general vesting requirements, the bill requires that, in the case of a multiemployer plan, a participant's accrued benefit derived from employer contributions be 100 percent vested no later than upon the participant's completion of 10 years of service.

Effective Date

The provisions are generally applicable for plan years beginning after December 31, 1988, with to participants who perform at least one hour of service in a plan year to which the new provision applies.

A special effective date applies to plans maintained pursuant to a collective bargaining agreement. Under this special rule, in the case of a plan maintained pursuant to a collective bargaining agreement between employee representatives and one or more employers ratified before March 1, 1986, the amendments are not effective for plan years beginning before the earlier of (1) the later of (i) January 1, 1989, or (ii) the date on which the last of the collective bargaining agreements terminates, or (2) January 1, 1991. Ex-

tensions or renegotiations of the collective bargaining agreement, if ratified after February 28, 1986, are disregarded.

4. Application of Nondiscrimination Rules to Integrated Plans (sec. 1211 of the bill, and sec. 401(1) of the Code)

Present Law

In general

Present law provides nondiscrimination standards for qualified pension, profit-sharing, and stock bonus plans. These standards prohibit discrimination in favor of employees who are officers, shareholders, or highly compensated. Under these standards, coverage tests are applied to determine whether the classification of employees who participate in a plan is discriminatory. Additional tests are applied to determine whether contributions or benefits under the plan discriminate in favor of highly compensated employees.

The rules prohibiting discrimination under qualified plans were adopted by the Congress in 1942. The nondiscrimination standard was adopted to "safeguard the public against the use of the pension plan as a tax-avoidance device by management groups seeking to compensate themselves without paying their appropriate taxes."[21] Congress was concerned that the requirement of nondiscriminatory coverage by a plan was not sufficient. Although nondiscriminatory coverage could assure that rank-and-file employees were not unfairly omitted from a plan, it could not assure that those employees would be provided with a fair share of benefits. Accordingly, the 1942 Act included standards requiring that a qualified plan provide nondiscriminatory benefits or contributions for plan participants. It was noted then that even ". . . extended coverage would not by itself guarantee that the pension plan would be operated for the welfare of employees generally, because the scale of benefits could be manipulated. Therefore, the scale of benefits must be nondiscriminatory."[22] In determining whether benefits were discriminatory, the Congress noted that plans designed in good faith to supplement social security should be permitted to qualify for favorable tax treatment.[23] Thus, a plan that provides benefits which, when aggregated with employer-provided social security benefits, constitute a nondiscriminatory percentage of compensation, is deemed to be nondiscriminatory even though plan benefits standing alone may not meet the nondiscrimination standard.

Integration of defined benefit pension plans

Generally, in applying the nondiscrimination test to benefits under a plan, the rate at which benefits are provided by the plan for highly compensated participants (as a percentage of their pay) is compared with the rate at which the plan provides benefits for other participants. A similar test may be applied to employer contributions under a plan. A plan fails the nondiscrimination stand-

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[21] H. Rpt. 77-2333, 77th Cong., 2d. Sess. 51 (1942).
[22] *Ibid.*
[23] See, e.g., S. Rpt. 1631, 77th Cong., 2d. Sess. 139 (1942).

ard if both benefits and contributions discriminate in favor of highly compensated employees.

Under present law, in determining whether defined benefit pension plan benefits, as a percentage of pay, discriminate in favor of employees who are highly compensated, the portion of each employee's social security benefits that is considered to be paid for by the employer may be taken into account. For this purpose, social security benefits mean old age, survivors, and disability insurance (OASDI) benefits provided under the social security system.

A plan that meets the nondiscrimination standards of the Code only if social security benefits are taken into account is referred to as an integrated plan. If these social security benefits and the employer-provided benefits under the plan, when added together, provide an aggregate benefit that is a higher percentage of pay for highly compensated employees than for other employees, then the benefits under the plan are discriminatory and the plan does not qualify. Either benefits or contributions under a plan may be integrated.

Two basic approaches to integration of defined benefit pension plans have been developed—(1) the "offset" approach, and (2) the "excess" approach.[24]

Offset plans

A defined benefit pension plan that integrates under the offset approach is referred to as an offset plan. An offset plan initially provides each employee with an annual pension benefit which (as a percentage of pay) does not discriminate in favor of highly compensated employees. For each employee, this initial benefit is then reduced, or offset, by the employer-provided portion of that employee's social security benefit to arrive at the actual pension benefit under the plan.

In 1971, the Internal Revenue Service determined that the value of employer-provided social security benefits is equal to 83-1/3 percent of the annualized primary insurance amount (PIA) to which an employee is entitled under the Social Security Act. This calculation forms the basis of the present-law rules for integrating offset plans. Consequently, an offset plan could integrate its benefits with social security by providing each employee an annual benefit of, for example, 50 percent of pay offset by 83-1/3 percent of the employee's PIA.

Excess plans

A pension plan that integrates under the excess approach is referred to as an excess plan. The basic theory underlying the excess approach is that social security provides benefits based on only a certain portion of an employee's earnings. An excess plan is designed to provide benefits (or added benefits) based on the portion of an employee's earnings "in excess" of the earnings on which social security benefits are provided (covered compensation). An excess plan integrates if the benefits it provides with respect to compensation in excess of covered compensation are not greater, as

[24] Rules for integrating under these two approaches are set forth in Rev. Rul. 71-446, 1971-2 C.B. 187.

a percentage of pay, than the benefits provided by social security on covered compensation.

The Internal Revenue Service determined that the employer-provided portion of benefits under social security averages 37-1/2 percent of the average maximum pay on which social security benefits are based. This calculation forms the basis of the present-law rules for integrating excess plans. Consequently, for an employee retiring at age 65 in 1986, an excess plan will integrate properly if it provides benefits at a rate no greater than 37-1/2 percent of pay in excess of $15,000 (approximately the highest average annual wage upon which social security benefits can be based for such an employee), although it provides no benefits with respect to the first $15,000 of pay.

If an excess plan provides benefits on compensation up to covered compensation, then it can provide benefits at a higher rate on pay above the level of covered compensation. However, the rate at which benefits are provided above covered compensation cannot exceed the rate at which benefits are provided on compensation up to covered compensation by more than 37-1/2 percent. For example, an integrated excess plan could provide benefits at the rate of 12-1/2 percent for all compensation plus 50 percent (i.e., 37-1/2 percent plus 12-1/2 percent) of compensation in excess of covered compensation.

Integration of defined contribution plans

Defined contribution plans do not provide specified benefit formulas. Defined contribution plans provide for contributions to be allocated to and accumulated in a separate account for each employee. Accordingly, such plans are integrated by taking into account the employer-paid portion of social security taxes. Specifically, a defined contribution plan is integrated by reducing contributions to the plan with respect to the portion of an employee's pay subject to the social security tax (i.e., the taxable wage base or $42,000 for 1986).

Prior to 1984, the integration of a defined contribution plan was based on the IRS-calculated cost of employer-provided social security benefits. For pre-1984 years, the Internal Revenue Service had determined that the employer's cost of providing social security benefits was 7 percent of pay subject to the tax.

Effective for plan years beginning after 1983, the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) revised the integration rules for profit-sharing and other defined contribution plans. TEFRA permits an employer to reduce plan contributions on behalf of an employee by no more than an amount equal to the employee's taxable wage base multiplied by the actual OASDI tax rate. Thus, a profit-sharing plan could provide contributions of 5.7 percent (the OASDI tax rate) of 1986 pay in excess of $42,000 (the 1986 taxable wage base) and no contributions for 1986 with respect to the first $42,000 of pay. Similarly, if a plan provided for 1986 contributions of 10 percent of pay in excess of $42,000, it would integrate properly only if it provided for 1986 contributions of at least 4.3 percent with respect to the first $42,000 of pay.

Top-heavy plans

A qualified plan that is top-heavy must provide a minimum nonintegrated benefit or contribution derived from employer contributions for each employee who is a participant in the plan and who is not a key employee (sec. 416). The rule is designed to reflect the higher proportion of tax benefits focused on key employees in a top-heavy plan.[25]

A defined benefit pension plan satisfies this minimum benefit requirement if, on a cumulative basis, the accrued benefit of each participant who is not a key employee, when expressed as an annual retirement benefit, is not less than two percent of the employee's average annual compensation from the employer, multiplied by the employee's years of service with the employer. However, an employee's minimum benefit is not required to exceed 20 percent of such average annual compensation. This required minimum benefit may not be eliminated or reduced on account of the employee's social security benefits attributable to contributions by the employer (i.e., the minimum benefit is a "nonintegrated" benefit).

For a plan year for which a defined contribution plan is a top-heavy plan, the employer generally must contribute on behalf of each plan participant who is not a key employee an amount not less than three percent of the participant's compensation. The minimum contribution must be made for each year in which the plan is top-heavy. However, special rules provide that if the employer's contribution rate for each participant who is a key employee for the plan year is less than three percent, then the required minimum contribution rate for each non-key employee generally is limited to the highest contribution rate for any key employee.

Amounts paid by the employer for the year to provide social security benefits for the employee are disregarded. Thus, the required minimum contribution for a non-key employee may not be eliminated or reduced on account of benefits attributable to social security taxes paid by the employer (i.e., the minimum contribution is a "nonintegrated" contribution).

Reasons for Change

Social security benefits do not adequately replace the preretirement earnings of low- or middle-income workers. Because of this fact, and because of the financial inability of many low- and middle-income workers to set aside sufficient savings for retirement, the Congress has provided tax incentives to encourage employers to provide such workers with additional retirement benefits under qualified plans. The present-law rules on social security integration, which permit an employer to eliminate any qualified plan benefits for lower-paid employees, undermine the original Congressional policy for providing the tax incentives for qualified plans.

In addition, the committee believes that the present-law integration rules are a substantial source of unnecessary complexity in the qualified plan area.

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[25] Generally, a plan is top-heavy if more than 60 percent of the benefits it provides are for key employees (sec. 416).

Accordingly, the bill contains provisions that revise and simplify the rules governing the integration of a qualified plan, and that ensure that all employees covered by the plan receive some minimum benefit.

Explanation of Provision

In general

The bill provides that a plan is not to be considered discriminatory merely because the contributions and benefits of (or on behalf of) employees under the plan favor highly compensated employees (sec. 414(q)) if the plan meets the new requirements of the bill relating to the integration of contributions or benefits.

Permitted disparity in defined contribution plans

In general.—Under the bill, a defined contribution plan meets the disparity limits for integrated plans only if the excess contribution percentage under the plan does not exceed the base contribution percentage by an amount specified in the bill. The bill provides that the excess contribution percentage is not to exceed the lesser of (1) 200 percent of the base contribution percentage, or (2) the sum of the base contribution percentage and the rate of the tax imposed on employers under the Federal Insurance Contributions Act (5.7 percent for 1986) as of the beginning of the plan year.

For example, under the bill, if a defined contribution plan provided for contributions of 10 percent of pay on compensation in excess of the taxable wage base, then the plan is required to provide contributions of at least 5 percent of pay on compensation up to the taxable wage base in order to satisfy the integration rules for defined contribution plans. Alternatively, if the plan provided contributions of 10 percent of pay on compensation up to the taxable wage base, then the contributions for pay in excess of the taxable wage base are limited to 15.7 percent because the permitted disparity cannot be greater than the OASDI tax rate (*i.e.*, 5.7 percent in 1986).

Contributions to a plan that are subject to the nondiscrimination rules in section 401(k) or 401(m) (or, in the case of simplified employer pensions, sec. 408(k)(6)) may not rely on these integration requirements, but rather must satisfy the separate nondiscrimination rules under such other provisions.

Excess contribution percentage.—Under the bill, the excess contribution percentage is the percentage of remuneration that is contributed under the plan with respect to that portion of remuneration in excess of the compensation level specified under the plan for the year.

Base contribution percentage.—The bill provides that the base contribution percentage is the percentage of remuneration contributed under the plan with respect to that portion of remuneration not in excess of the compensation level specified under the plan for the year.

Under the bill, the compensation level refers to the dollar amount of remuneration specified under the plan as the compensation level for the year. The compensation level specified in the plan may not exceed the contributions or benefit base under the Social

Security Act (i.e., the taxable wage base) in effect at the beginning of the plan year ($42,000 for plan years beginning in 1986). In addition, an employer may not set a lower compensation level if such level discriminates in favor of highly compensated employees.

Remuneration.—Remuneration is defined as total compensation, or basic or regular compensation, whichever is used in determining contributions or benefits under the plan. With respect to a self-employed individual, the bill provides that compensation includes the individual's earned income. The self-employed individual's basic or regular rate of compensation is equal to the portion of the individual's earned income that bears the same ratio to his earned income as the regular or basic compensation of employees under the plan bears to the total compensation of such employees.

Permitted disparity in defined benefit pension plans

In general

Under the bill, a defined benefit pension plan meets the requirement for integrated plans only if it meets the requirements for integrated offset plans or those for integrated excess plans. Under a special limitation provided by the bill, a defined benefit pension plan will not fail to meet the nondiscrimination rules (sec. 401(a)(4)) merely because it limits benefits by reference to the final pay of a participant.

Excess plans

In general.—A defined benefit pension plan meets the disparity limits for integrated excess plans if (1) the excess benefit percentage does not exceed 200 percent of the base benefit percentage, and (2) any optional form of benefit, preretirement benefit, actuarial factor, or other benefit or feature provided by the plan with respect to remuneration in excess of the compensation level specified by the plan for the year is provided with respect to remuneration that is not in excess of that level.

Benefit percentages.—Under the rules for integration of defined benefit pension plans as excess plans, the excess and base benefit percentages are to be computed in the same manner as those percentages are to be computed for defined contribution plans, except that the computation is to be based on benefits rather than contributions. Thus, the term the "excess benefit percentage" refers to the benefits provided under the plan (expressed as a percentage of remuneration) with respect to that portion of remuneration in excess of the compensation level specified in the plan. The base benefit percentage refers to the benefits provided under the plan (expressed as a percentage of remuneration) with respect to that portion of remuneration not in excess of the compensation level specified in the plan.

For purposes of the rules relating to defined benefit excess plans, the terms "compensation level" and "remuneration" have the same meanings as for purposes of the rules relating to defined contribution plans.

Offset plans

In general.—A defined benefit pension plan meets the requirements for integrated offset plans if it provides that a participant's accrued benefit derived from employer contributions (sec. 411(c)(1)) may not be reduced by reason of the offset by more than 50 percent of the benefit that would have accrued without regard to the reduction. The bill provides that a defined benefit pension plan is an offset plan if each participant's normal retirement benefit derived from employer contributions (sec. 411) is reduced (offset) by a dollar amount specified by the plan and if the same dollar amount of reduction is applicable to all plan participants. The Secretary is directed to prescribe rules for "normalizing" benefits, though not necessarily in the manner described in Rev. Rul. 81-202, and for preventing discriminatory modifications in the amount of the dollar offset from year to year.

Example.—Under an offset plan, the offset may never reduce a participant's accrued benefit by more than 50 percent, and may accrue no faster than the rate at which the participant's benefit under the plan would accrue without regard to the offset. For example, assume that a plan provides for a normal retirement benefit of 50 percent of final pay, less $20,000. The plan provides that the participant's accrued benefit is to accrue under the fractional accrual rule of section 411(b). Normal retirement age under the plan is age 65. Assume that a participant commences working for the employer and becomes a participant in the plan at age 40. Upon the date that the participant has completed 5 years of service with the employer, the participant has an accrued benefit (without regard to the dollar offset) of 5/25ths of 50 percent of final pay (or 10 percent of final pay). At that time, the value of the offset "accrued" to the participant may not exceed the lesser of (a) 5/25ths of $20,000 ($4,000), or (b) one-half of the participant's accrued benefit (determined without regard to the offset) to date.

Multiple plans

The bill provides rules that apply to a plan that benefits a highly compensated employee (sec. 414(q)) who participates in 2 or more plans maintained by the employer that would be considered discriminatory but for the integration rules. In such a case, the integration rules are to be applied to each of the plans by taking into account the total contributions and benefits for such highly compensated employee under all of such plans of the employer.

Benefits limited by reference to final pay

The bill provides that a defined benefit pension plan (including an offset or excess plan) is not to be considered discriminatory merely because it provides that the employer-provided accrued retirement benefit for any participant under the plan is not to exceed the excess (if any) of (1) the participant's final pay with the employer, over (2) the employer-provided retirement benefit, created under Federal law, that is attributable to the participant's service with the employer. The Secretary shall prescribe rules for "normalizing" accrued benefits for purposes of this rule. Also, this limit may

not be applied to reduce minimum benefits under the top-heavy rules.

Under the bill, for purposes of determining the final-pay limit that may be imposed by an integrated defined benefit pension plan, a participant's final pay is the total compensation paid to the participant by the employer during the participant's highest year of compensation ending with or within the 5-year period ending with the year in which the participant separated from service with the employer.

Effective Date

The provisions are effective for plan years beginning after December 31, 1988.

A special effective date applies to plans maintained pursuant to a collective bargaining agreement. Under this special rule, in the case of a plan maintained pursuant to a collective bargaining agreement between employee representatives and one or more employers ratified before March 1, 1986, the amendments are not effective for plan years beginning before the earlier of (1) the later of (i) January 1, 1989, or (ii) the date on which the last of the collective bargaining agreements terminates, or (2) January 1, 1991. Extensions or renegotiations of the collective bargaining agreement, if ratified after February 28, 1986, are disregarded.

5. Benefits Treated as Accruing Ratably for Purposes of Determining Whether Plan is Top-Heavy (sec. 1218 of the bill and sec. 416 of the Code)

Present Law

In general

For years beginning after December 31, 1983, present law provides additional qualification requirements for plans that primarily benefit an employer's key employees (top-heavy plans) (sec. 416). These additional requirements (1) limit the amount of a participant's compensation that may be taken into account, (2) provide greater portability of benefits for plan participants by requiring more rapid vesting, (3) provide minimum nonintegrated contributions or benefits for plan participants who are non-key employees, and (4) reduce the aggregate limit on contributions and benefits.

Top-heavy plan calculation

A defined benefit pension plan generally is top-heavy for a year if, as of the determination date for such year, the present value of the cumulative accrued benefits for participants who are key employees exceeds 60 percent of the present value of the cumulative accrued benefits for all employees under the plan. A defined contribution plan is a top-heavy plan for a year if, as of the determination date for such year, the sum of the account balances of participants who are key employees exceeds 60 percent of the sum of the account balances of all employees under the plan (sec. 416(g)).

Accrued benefits

In general, a defined benefit pension plan will not be considered a qualified plan unless participants accrue benefits at a rate that meets one of three alternative schedules (sec. 411(b)). The purpose of these schedules generally is to limit the extent to which an employer may defer (i.e., "backload") benefit accruals.

Under the first alternative, known as the "three-percent rule," a plan participant must accrue a benefit during each year of participation (up to 33-1/3 years) not less than three percent of the benefit to which an employee who entered the plan at the earliest entry age and participated until the earlier of normal retirement age or age 65 would otherwise be entitled.

Under the second alternative, known as the "133-1/3-percent rule," a plan will satisfy the accrued benefit requirements if the accrued benefit of a plan participant, as of his normal retirement age, is equal to the normal retirement benefit under the plan and the annual rate at which any individual who is or could be a plan participant accruing the retirement benefits in any year, is never more than 133-1/3 percent of the annual accrual rate for any prior year.

Under the third alternative, known as the "fractional rule," each plan participant's accrued benefit at the end of any year must be at least equal to a fractional portion of the retirement benefit to which the participant would be entitled under the plan's benefit formula if the participant continued to earn annually until normal retirement age the same rate of compensation. The fractional portion is determined by dividing the participant's actual years of participation by the total number of years of participation that would have been completed if the participant had continued in service until normal retirement age.

In determining whether a plan is top-heavy, cumulative accrued benefits are calculated using the benefit accrual method selected by the plan. If the plan is determined to be top-heavy, the plan generally must provide that each participant's minimum benefit is, on a cumulative basis, at least equal to two percent of compensation for each year of service during which the plan is top-heavy, not to exceed 20 percent (sec. 416(c)). Under the top-heavy rules, benefits accrued under the plan's benefit formula must be at least equal to the required minimum benefit.

Reasons for Change

The committee is concerned that some employers are trying to avoid application of the top-heavy plan rules by artificially accelerating benefit accruals for non-key employees. If the acceleration is sufficient to ensure that the plan does not provide more than 60 percent of the benefits for key employees, the top-heavy rules (including the top-heavy minimum benefit and vesting rules) will not apply. As a result, the non-key employees often forfeit the benefits. The committee believes that it is appropriate to measure accrued benefits on a uniform basis to protect the benefits of rank-and-file employees.

Explanation of Provision

Under the bill, a uniform accrual rule is used in testing whether a qualified plan is top-heavy (or super top-heavy) (sec. 416(g)(4)(F)). Thus, solely for determining whether the present value of cumulative accrued benefits for key employees exceed 60 percent of the present value of cumulative accrued benefits for all employees (90 percent for purposes of the super top-heavy plan rules), cumulative accrued benefits are to be uniformly measured by applying the fractional rule. Thus, benefits will be treated as accruing no more rapidly than required under the fractional rule.

This rule applies only for purposes of determining whether the plan is top heavy- or super top-heavy. The rule does not require that the plan actually use the fractional rule for purposes of accruing benefits under the plan.

Effective Date

The provision applies for plan years beginning after December 31, 1986.

6. Modification of Rules for Benefit Forfeitures (sec. 1219 of the bill and sec. 401 of the Code)

Present Law

Under present law, ERISA and the Code generally require that (1) a participant's benefits be fully vested upon attainment of the normal retirement age specified in the plan; (2) a participant be fully vested at all times in the benefit derived from employee contributions; and (3) employer-provided benefits vest at least as rapidly as under one of three alternative minimum vesting schedules (sec. 411(a)). Under these schedules, an employee's right to benefits derived from employer contributions becomes nonforfeitable (vested) to varying degrees upon completion of specified periods of service with an employer.

When a participant separates from service, and receives a distribution of his vested plan interest or incurs a five-year break in service-nonvested benefits may be forfeited. In a defined benefit pension plan-forfeitures may not be used to increase promised benefits because benefits must be definitely determinable; instead, forfeitures must be used to reduce future employer contributions or to offset plan administrative expenses.

The treatment of forfeitures in a defined contribution plan depends on whether or not the plan is a money purchase pension plan. In a defined contribution plan that is not a money purchase plan (e.g., a profit-sharing or stock bonus plan), forfeitures may be reallocated to the remaining participants under a formula that does not discriminate in favor of employees who are officers, shareholders, or highly compensated. These reallocated forfeitures increase the benefits of the remaining participants. Alternatively, forfeitures can be used to reduce future employer contributions.

A money purchase pension plan, like a defined benefit plan, is subject to the requirement that benefits be definitely determinable. Accordingly, a money purchase plan must contain a definite contribution formula. Present law also provides that forfeitures may not

be used to increase benefits, but must be applied to reduce future employer contributions or administrative costs (sec. 401(a)(8)).

Reasons for Change

The committee believes it is appropriate to provide uniform rules for the treatment of forfeitures under all types of defined contribution plans.

Explanation of Provision

The bill creates uniform rules for forfeitures under any defined contribution plan. The bill permits, but does not require, forfeitures to be reallocated to other participants. Thus, forfeitures arising in any defined contribution plan (including a money purchase pension plan) can be either (1) reallocated to the accounts of other participants in a nondiscriminatory fashion, or (2) used to reduce future employer contributions or administrative costs.

Effective Date

The provision is effective for years beginning after December 31, 1985.

Revenue Effect of Part B

These provisions are estimated to increase fiscal year budget receipts by less than $5 million annually.

C. Treatment of Distributions

1. Uniform Minimum Distribution Rules (sec. 1221 of the bill and secs. 401, 403, 408, and new sec. 4974 of the Code)

Present Law

Before-death distribution rules

Under present law, a trust is not a qualified trust unless the plan of which it is a part provides that the entire interest of each participant will be distributed no later than the participant's required beginning date (sec. 401(a)(9)). Alternatively, the requirements of present law may be satisfied if the participant's entire interest is to be distributed in substantially nonincreasing annual payments, beginning no later than the participant's required beginning date, over (1) the life of the participant, (2) the lives of the participant and a designated beneficiary, (3) a period (which may be a term certain) not extending beyond the life expectancy of the participant, or (4) a period (which may be a term certain) not extending beyond the life expectancies of the participant and a designated beneficiary.

A participant's required beginning date is generally April 1 of the calendar year following the calendar year in which (1) the participant attains age 70-1/2 or (2) the participant retires, whichever is later. If a participant is a 5-percent owner (sec. 416(i)) with respect to the plan year ending in the calendar year in which the participant attains age 70-1/2, then the required beginning date is generally April 1 of the calendar year following the calendar year in which the participant attains age 70-1/2 even though the participant has not retired. If the participant delays the commencement of benefits to April 1 of the year following the year in which the participant attains age 70-1/2 or separates from service, the amount to be distributed should be adjusted to reflect the amounts that would have been paid if distribution had not been delayed.

In addition, the distribution of benefits under a qualified plan must satisfy the incidental benefits rule.[26] Under the incidental benefits rule, a qualified plan generally is required to provide for a form of distribution under which the present value of the payments projected to be made to the participant, while living, is more than 50 percent of the present value of the total payments projected to be made to the participant and the participant's beneficiaries. However, a distribution pattern is not prohibited by the incidental benefits rule to the extent that it is required by the rules relating to qualified joint and survivor annuities (sec. 401(a)(11)).

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[26] See, e.g., Rev. Rul. 72-241, 1972-1 C.B. 108.

After-death distribution rules

Present law provides a minimum distribution requirement with respect to benefits payable from a qualified plan with respect to a participant who has died. The applicable rules depend upon whether benefits commenced before or after the participant's death.

If the distribution of benefits commenced to the participant before death, the remaining portion of the participant's interest is to be distributed at least as rapidly as under the method of distribution in effect prior to death. Where benefits did not commence prior to the death of the participant, present law requires that the entire interest of the participant be distributed within 5 years after the date of death unless the after-death distribution method meets certain requirements.

Under present law, the 5-year distribution requirement does not apply to the portion of a participant's after-death remaining interest payable to a designated beneficiary over the life of the designated beneficiary (or over a period (including a term certain) not extending beyond the life expectancy of the beneficiary) if (1) those distributions commence no later than 1 year after the date of death, and (2) the distributions are paid to the designated beneficiary under rules that meet the minimum distribution requirements for before-death distributions. A second exception to the 5-year distribution requirement applies if the designated beneficiary is the surviving spouse of the participant.

IRAs

Present law provides before and after-death minimum distribution rules for IRAs corresponding to the rules applicable to qualified plans. Distributions from an IRA, however, are required to commence no later than April 1 of the calendar year following the calendar year in which the owner of the IRA attains age 70-1/2.

Reasons for Change

For employees other than 5-percent owners, present law uses separation from service after age 70-1/2 as the date benefit distributions from a qualified plan must commence. For 5-percent owners and all IRA owners, distributions are required to commence at age 70-1/2 without regard to separation from service. Thus, the rules allow the longer deferral of tax on accumulations under a plan for participants who are not 5-percent owners, but who may be highly paid and, in some instances, effectively in control of their employer. An individual who can control the timing of receipt of a benefit by controlling the terms of a plan is more analogous to the owner of an IRA, for whom distributions are required to commence at age 70-1/2.

In addition, the time of separation from service for highly compensated individuals is sometimes difficult to determine, as in the case of influential employees who cease their regular duties, but continue to work in connection with consulting agreements in order to postpone commencement of benefit payments. The committee believes that the extension of the required beginning date for 5-percent owners to highly compensated employees of an employer would ease administrative burdens in the private and public sec-

tors by eliminating the need for a subjective test to determine when withdrawals are required to begin for such individuals.

In addition, the extension of the benefit commencement date for 5-percent owners to other highly compensated employees would help to ensure that such plans are used to fulfill the purpose that justifies their tax-favored status—replacement of a participant's preretirement income stream at retirement—rather than for the indefinite deferral of tax on a participant's accumulation under the plan.

The committee believes that uniform sanctions should apply to violations of the minimum distribution rules. The sanction of disqualification, however, is too onerous for a plan's failure to satisfy the highly technical distribution requirements with respect to any one participant. Disqualification may result in adverse tax consequences to all plan participants, even though the plan administrator generally is outside the control of the participants, and the failure may have occurred with respect to only a single participant. Plan disqualification procedures also impose a significant administrative burden on the IRS. Although the committee believes that a plan should, by its terms, prohibit the violation of the minimum distribution rules, the committee also believes an operational error should not cause plan disqualification.

Explanation of Provisions

Overview

The bill extends the required benefit commencement date for 5-percent owners to all participants in a plan who are highly compensated employees, as that term is defined in the bill. In addition, the bill establishes a new sanction in the form of an excise tax, as an alternative to plan disqualification, for failure to satisfy the minimum distribution rules.

Benefit commencement date

General Rule.—Under the bill, distributions under all qualified defined benefit and defined contribution plans in which an individual participates are required to commence no later than April 1 of the calendar year following the calendar year in which (1) the participant attains age 70-1/2 or (2) the participant retires, whichever is later.

Because the committee is concerned that an individual may attempt to avoid these rules by continuing to perform a small amount of services for the employer after separation from service and, therefore, argue that separation from service has not occurred, the committee intends that the Secretary of the Treasury shall prescribe rules to treat an individual as separated from service if the employee performs only de minimis services for the employer during the year.

In addition, with respect to a participant who is a "highly compensated employee" for any plan year ending in the calendar year after the calendar year in which the employee attains age 65-1/2, the participant's benefits under the plan are to commence no later than the April 1 of the calendar year following the calendar year in which the participant attains age 70-1/2 or, if later, April 1 of

the calendar year following the calendar year in which ends the plan year in which the participant becomes a highly compensated employee.

As under present law, distributions under an IRA are required to begin no later than April 1 of the calendar year following the calendar year in which the owner of the IRA attains age 70-1/2.

Highly compensated employee.—The definition of a highly compensated employee for purposes of the benefit commencement rules is the same as the definition for purposes of the coverage and nondiscrimination rules contained in the bill.

Under the bill, an employee is treated as highly compensated with respect to a year if, at any time during the year or the preceding year, the employee (1) was a 5-percent owner of the employer (as defined in sec. 416(i)); (2) earned more than $100,000 in annual compensation from the employer; (3) earned more than $50,000 in annual compensation from the employer and was a member of the top-paid group of the employer during the same year; or (4) was an officer of the employer (as defined in sec. 416(i)). The $50,000 and $100,000 thresholds are indexed by reference to the method, as of May 1, 1986, of percentage increases in the social security wage base (i.e., at the same time and in the same manner as the adjustments to the dollar limits on benefits under defined benefit pension plans).

The bill provides that the top-paid group of employees includes all employees who are in the top 20 percent of all employees on the basis of compensation paid during the year. For purposes of the required distribution rules, the top 20 percent of all employees is determined in the same manner as that group is determined under the general rules for identifying the highly compensated employees in whose favor discrimination is prohibited. (See Part A, number 2, for a discussion of those rules.)

Excise tax on failure to make a minimum required distribution

Under the bill, the sanction for failure to make a minimum required distribution to a particular participant under a qualified retirement plan is a 50-percent nondeductible excise tax on the excess in any taxable year of the amount that should have been distributed (the "minimum required distribution") over the amount that actually was distributed. The term "qualified retirement plan" refers to a qualified plan described at section 401(a), a qualified annuity plan described at section 403(a), and an IRA.

The tax is imposed on the individual required to take the distribution. However, as under present law, a plan will not satisfy the qualification requirements unless it expressly provides that, in all events, distributions under the plan must satisfy the minimum distribution requirements and the incidental benefits rule.

Under the bill, the Secretary of the Treasury is authorized to waive the tax for a given taxable year if the taxpayer to whom the tax would otherwise apply is able to establish that any shortfall between the minimum required distribution for that year and the amount actually distributed during the year is due to reasonable error, and that reasonable steps are being taken to remedy the shortfall.

The minimum required distribution in any given taxable year is to be determined under regulations to be issued by the Treasury. The committee intends that where a participant selects a permissible distribution option, the minimum required distribution in any given year is to be the amount required to be distributed in that year under the payout option selected.

If the participant selects an impermissible payout option, the committee intends that the minimum required distribution in any year be the amount that would have been distributable to the participant in that year had the participant selected a joint and survivor annuity payable over the life expectancies of the participant and the beneficiary (if any) actually designated by the participant, taking into account their actual ages. The survivor benefit is assumed to be the maximum percentage of the annuity payable during the participant's lifetime that will not violate the incidental benefits rule. It is intended that the excise tax apply even if the distribution is described in the plan and the plan receives a favorable determination letter.

The excise tax applies in the case of a distribution from a plan that was, at any time, determined to be a qualified plan, or an IRA. Thus, the tax applies even if the plan is not qualified at the time of distribution.

Effective Dates

The provisions generally apply to years beginning after December 31, 1986.

In addition, an employee is not subject to the 50-percent excise tax for failure to satisfy the minimum distribution requirements merely because distributions are made to the employee in accordance with a designation made before January 1, 1984, by the employee in accordance with sec. 242(b)(2) of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA).

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by less than $5 million annually.

2. Taxation of Distributions (sec. 1222 of the bill and secs. 72, 402 and 403 of the Code)

Present Law

In general

Generally, a distribution of benefits from a tax-favored retirement arrangement is includible in gross income. In the case of a distribution from a qualified plan or an IRA, such a distribution is includible in the year in which it is paid or distributed.

Lump-sum distributions

Under present law, a lump-sum distribution from a qualified plan may qualify for special 10-year forward income averaging. In addition, the portion of a lump sum attributable to contributions prior to January 1, 1974, may qualify for capital gains treatment.

The portion of a lump-sum distribution that is eligible for capital gains treatment is determined by multiplying the lump-sum distribution by a fraction, the numerator of which is the number of years of active participation by the employee in the plan prior to January 1, 1974, and the denominator of which is the total number of years of active participation by the employee in the plan.

Basis recovery

Present law provides special rules for the treatment of basis (e.g., employee contributions) when an individual receives a distribution from a tax-favored retirement arrangement. If an amount is received before the annuity starting date (i.e., the date on which an amount is first received as an annuity), the individual is treated as first receiving employee contributions, which are nontaxable, and taxable income second.

In the case of amounts received after the annuity starting date in the form of an annuity, each payment received by an employee generally is treated, in part, as a return of the employee's contributions and, in part, as taxable income. The portion of each payment treated as a return of employee contributions is that amount that bears the same ratio to each payment as the employee's total contributions bear to his total expected payments over the period of the annuity. In the case of a straight-life annuity, the employee's life expectancy, as of his annuity starting date, is treated as the period over which the annuity is to be paid for purposes of computing his total expected return under the contract. Where the employee dies prior to the expiration of his anticipated life expectancy, no deduction is provided for the employee's unrecovered basis. On the other hand, an employee whose actual life is longer than anticipated at the time his benefits commence effectively excludes from income an amount in excess of the employee's total contributions.

In addition, under present law, a special rule applies under certain circumstances to annuity payments from qualified plans. Under the special rule, if an individual's first 3 years of annuity payments after the annuity starting date will equal or exceed the individual's aggregate employee contributions, all distributions are treated as a return of employee contributions (and thus nontaxable) until all of the individual's employee contributions have been recovered. Thereafter all distributions are fully taxable.

Reasons for Change

The special 10-year averaging and capital gains provisions for lump-sum distributions (including lump-sum distributions before retirement) under present law encourage individuals to withdraw tax-favored funds from the retirement income stream before retirement and are inconsistent with the policy of providing individuals with income at retirement. The original purpose of the capital gains and 10-year averaging provisions were to mitigate the effect of the progressive tax structure on individuals receiving all of their benefits in a single year. The same purpose is now served, however, by permitting individuals generally to roll over distributions into an IRA. This results in the individual being taxed only as amounts

are subsequently withdrawn from the IRA. Because rollovers are permitted, income averaging and capital gains treatment are less appropriate incentives to consume retirement monies, and are inappropriate with respect to distributions prior to age 59-1/2. Thus, the committee believes that 5-year averaging and capital gains treatment should be available only on a limited basis and should be adjusted to reflect the decreased need for income averaging, given the tax structure in the committee's bill.

Similarly, the basis recovery rules for early distributions permit the accelerated tax-free recovery of employee contributions and thus further encourage the use of tax-favored plans for nonretirement purposes. The three-year basis recovery rule provides favorable tax treatment to a limited class of taxpayers, which is inequitable to other taxpayers.

Explanation of Provisions

Overview

The bill generally (1) phases out capital gains treatment over 6 years (except for certain grandfathered individuals); (2) eliminates 10-year forward averaging (except for certain grandfathered individuals) and permits 5-year forward averaging under limited circumstances; (3) modifies the present-law basis recovery rules for amounts distributed prior to a participant's annuity starting date; (4) eliminates on a phased-in basis the special three-year basis recovery rule of present law; (5) modifies the general basis recovery rules for amounts paid as an annuity; and (6) provides basis recovery rules for distributions from an IRA to which nondeductible contributions have been made.

10-year averaging and pre-1974 capital gains treatment

The bill generally repeals 10-year forward averaging, phases out pre-1974 capital gains treatment over a 6-year period, and makes 5-year forward averaging (calculated in the same manner as 10-year averaging under present law) available for one lump-sum distribution received by an individual on or after attainment of age 59-1/2.

Under the bill, individuals are permitted to make a one-time election with respect to a single lump sum received on or after the individual attains age 59-1/2 to use 5-year forward averaging. In addition, the bill provides a special transition rule under which any participant who attains age 50 by January 1, 1986, is permitted to make one election with respect to a single lump-sum distribution to use 5-year forward averaging (under the new tax rates) or 10-year averaging (under current tax rates), without regard to the requirement of attainment of age 59-1/2. An election under the special transition rule to use income averaging on a lump sum received prior to age 59-1/2 eliminates the availability of an election after age 59-1/2 under the general rule.

The bill also provides a special transition rule under which individuals who have attained age 50 by January 1, 1986, may elect capital gains treatment with respect to a lump-sum distribution, without regard to the six-year phase-out of capital gains treatment.

Finally, the bill does not modify the present-law rules governing the availability of net unrealized appreciation on employer securities.

Basis recovery rules

Overview.—The bill modifies the basis recovery rules applicable to distributions from plans in which there are after-tax employee contributions by (1) eliminating the 3-year basis recovery rule for distributions in annuity form after the annuity starting date, and (2) requiring, with respect to distributions prior to the annuity starting date, that after-tax employee contributions be recovered on a pro-rata basis. The bill also provides rules governing the recovery of basis on distributions from an IRA to which the individual has made nondeductible contributions.

Pre-annuity starting date distributions.—The bill modifies the basis recovery rules for pre-annuity starting date distributions to provide for the pro rata recovery of employee contributions. Thus, with respect to a pre-annuity starting date distribution, a participant is entitled to exclude that portion of the payment that bears the same ratio to the total payment as the participant's after-tax employee contributions (and amounts treated as after-tax employee contributions) bears to the total value of the participant's accrued benefit (or account balance) under the plan as of the date of distribution or as of such other time as the Secretary may prescribe. The Secretary is authorized to prescribe appropriate rules for estimating the amounts referred to in the prior sentence where precise calculation would be unjustifiably burdensome.

If an employee is only partially vested in the portion of his benefits attributable to employer contributions (for example, in the case of a plan with a graded vesting schedule), the portion of the employee's accrued benefit that has not yet vested is not taken into account in determining the total value of the participant's accrued benefit.

Post-annuity starting date distributions.—With respect to amounts received in the form of an annuity after the annuity starting date, the special 3-year basis recovery rule is eliminated. Thus, an employee must include in income a portion of each payment made on or after the employee's annuity starting date.

The bill limits the total amount that an employee may exclude from income to the total amount of the employee's contribution. In addition, if an employee's benefits cease prior to the date the employee's total contributions have been recovered, the amount of unrecovered contributions is allowed as a deduction to the annuitant for his last taxable year. For purposes of the provisions of present law relating to net operating losses, the deduction is treated as related to a trade or business of the employee.

As under present law, with respect to distributions that are not received in the form of an annuity and that are paid after the annuity starting date, the amount is deemed to be attributable first to income on the contract.

Individual Retirement Accounts.—The basis recovery rules for distributions from an IRA to which nondeductible contributions have been made generally are similar to the rules applicable to dis-

tributions from a qualified plan. See the description in Part A., 1., above.

Effective Dates

The provisions relating to the taxation of lump-sum distributions are effective for distributions made after December 31, 1986.

The provisions relating to the basis recovery rules for amounts received before a participant's annuity starting date are generally effective for distributions made after December 31, 1986, but do not apply to employee contributions made prior to January 1, 1987 to the extent that, on May 5, 1986, such contributions were available for distribution under a plan before separation from service. Thus, except in the case of plans in which substantially all contributions are employee contributions, withdrawals made after the effective date, but prior to an individual's annuity starting date, are to be treated as made first from pre-1987 employee contributions that were available for in-service withdrawal. After all such contributions have been recovered, any subsequent distributions are taxed under the new pro-rata basis recovery rules of the bill.

The repeal of the special 3-year basis recovery rule generally is effective with respect to any individual whose annuity starting date is after January 1, 1988. If the employee's annuity starting date is after January 1, 1988, but on or before January 1, 1989, and the amount to be distributed during the first 3 years under the annuity is greater than the employee's total basis, then 50 percent of such basis may be recovered before any amounts are taxable. After the first 50 percent of the participant's basis has been recovered, the remaining 50 percent is to be recovered under the general pro-rata basis recovery rule for post-annuity starting date distributions.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $92 million in 1987, $96 million in 1988 $847 million in 1989, $1,952 million in 1990, and $2,354 million in 1991.

3. Uniform Additional Income Tax for Early Distributions from Qualified Retirement Plans (sec. 1223 of the bill and secs. 72, 401, and 403 of the Code)

Present Law

Withdrawal restrictions

Under present law, benefits may be distributed to a participant in a qualified pension plan only on account of plan termination or the employee's separation from service, disability, or death. In-service withdrawals are not permitted under a qualified pension plan before normal retirement age.

Withdrawals under qualified profit-sharing or stock bonus plans are subject to fewer restrictions than those under qualified pension plans. Qualified profit-sharing or stock bonus plans generally may permit the withdrawal of employer contributions after the expiration of a stated period of time (e.g., 2 years or longer) or after the occurrence of a stated event (e.g., hardship).

Special restrictions apply to benefits under a qualified cash or deferred arrangement. Under present law, a qualified cash or deferred arrangement, by its terms, may not permit a participant to withdraw elective deferrals (or earnings on such deferrals) before the participant dies, becomes disabled, separates from service, (except in the case of a pre-ERISA money purchase pension plan) attains age 59-1/2, or encounters hardship. Under proposed regulations, an employee is treated as having incurred a hardship only to the extent that the employee has an immediate and heavy bona fide financial need and does not have other resources reasonably available to satisfy the need. Present law does not permit distributions under a qualified cash or deferred arrangement on account of plan termination.

Distributions from an employee stock ownership plan (ESOP) are required to satisfy the distribution rules applicable to qualified plans. In addition, employer securities allocated to a participant's account under a tax credit ESOP may not be distributed before the end of 84 months after the security was allocated to the participant's account.

Additional income tax on early withdrawals

Generally, under present law, a 10-percent additional income tax is imposed on withdrawals from an IRA before the owner of the IRA attains age 59-1/2, dies, or becomes disabled. The tax also applies to any withdrawals from qualified plans by or on behalf of 5-percent owners who have not yet attained age 59-1/2, died, or become disabled.

Notice of rollover treatment

Under present law, if an employee's benefits are paid to the employee or to the surviving spouse of the employee as a qualifying rollover distribution, all or any portion of the distribution may be rolled over, within 60 days of the date of the distribution, to an IRA or, in certain circumstances, to another qualified plan. If a rollover is made, tax is deferred on the portion of the distribution rolled over.

When the administrator of a qualified plan makes a qualifying rollover distribution, the administrator is required to provide notice to the recipient that (1) the distribution will not be taxed currently to the extent transferred to another qualified plan or an IRA, and (2) the transfer must be made within 60 days of receipt in order to qualify for this tax-free rollover treatment.

Reasons for Change

Present law imposes withdrawal sanctions with respect to certain tax-favored retirement arrangements and requires withdrawal restrictions to be provided under others. The absence of withdrawal restrictions in the case of some tax-favored arrangements allows participants in those arrangements to treat them as general savings accounts with favorable tax features rather than as retirement savings arrangements. Moreover, taxpayers who do not have access to such arrangements, in effect, subsidize the general pur-

pose savings of those whose employers maintain plans with liberal withdrawal provisions.

Although the committee recognizes the importance of encouraging taxpayers to save for retirement, the committee also believes that tax incentives for retirement savings are inappropriate unless the savings generally are not diverted to nonretirement uses. One way to prevent such diversion is to impose an additional income tax on early withdrawals from tax-favored retirement savings arrangements in order to discourage withdrawals and to recapture a measure of the tax benefits that have been provided. Accordingly, the committee believes it appropriate to apply an early withdrawal tax to all tax-favored retirement arrangements. For the same reasons, the committee believes it is appropriate to limit the extent to which participants may make hardship withdrawals from a qualified cash or deferred arrangement.

Moreover, the committee is concerned that the present-law level of the additional income tax appears in many instances to be an insufficient deterrent to the use of retirement funds for nonretirement purposes, because for taxpayers whose income is taxed at a higher marginal rate, the sanction may be neutralized by the tax-free compounding of interest after a relatively short period of time, particularly with respect to amounts contributed to a retirement arrangement on a before-tax basis. Accordingly, the committee believes it to be appropriate to increase the tax from 10 to 15 percent, except with respect to (a) withdrawals of income (and employer matching contributions, if any), attributable to after-tax employee contributions, and (b) withdrawals of income attributable to nondeductible IRA contributions. The committee recognizes that actual retirement may commonly commence before age 59-1/2 in some industries and, therefore, provides an exception to the tax for the early commencement of a participant's benefits. The committee also believes it appropriate to provide, under limited circumstances, an exemption from the tax for certain withdrawals on account of specified hardships.

In addition, the committee believes it appropriate to exempt from the additional income tax on early distributions amounts distributed from employee stock ownership plans (ESOPs). The committee recognizes that the purpose of ESOPs is to create for employees an ownership interest in employer securities and believes that this special purpose warrants distinguishing ESOPs from plans the primary purpose of which is to provide retirement savings.

Finally, the committee recognizes that the present-law prohibition on distributions from qualified cash or deferred arrangements upon plan termination imposes significant administrative burdens on the trustees of such plans who must administer the related trust until all participants have retired or separated from service.

Explanation of Provisions

Withdrawal restrictions

Under the bill, a qualified cash or deferred arrangement may make distributions on account of the plan's termination (provided no successor plan is established), as well as on account of the em-

ployee's death, disability, separation from service, or (except in the case of a pre-ERISA money purchase pension plan) attainment of age 59-1/2. The bill provides that a distribution on account of the termination of a qualified cash or deferred arrangement must consist of the participant's total account balance under the plan. Distributions on account of hardship are permitted only to the extent of an employee's elective deferrals (but not income on those deferrals under the cash or deferred arrangement). Present-law standards governing what constitutes a "hardship" continue to apply.

The bill also provides that upon the sale by a corporation of the corporation's interest in a subsidiary (within the meaning of sec. 409(d)(3)), a distribution from a qualified cash or deferred arrangement may be made to an employee of the subsidiary even if the employee continues employment with the subsidiary.

In addition, under the bill, distributions from a tax credit ESOP are permitted upon the plan's termination (provided no successor plan is established) regardless of whether the 84-month rule has been satisfied. The committee also intends that the sale of securities held by a tax credit ESOP, and the transfer of those proceeds to another qualified plan, is permitted upon the termination of the ESOP. See the description in Part G, below.

Additional income tax on early distributions

Overview.—The bill (1) generally extends the additional income tax on premature distributions from an IRA to early distributions by any participant from any qualified retirement plan, as that term is defined in the bill; (2) increases the additional income tax on premature distributions from 10 to 15 percent for all early distributions other than distributions of income and employer matching contributions attributable to after-tax employee contributions and income attributable to nondeductible IRA contributions; (3) exempts certain distributions from the tax; and (4) requires that an employer offer an employee who separates from service and who elects to receive a lump-sum distribution the option of a direct transfer of the benefit to an IRA.

Amount of tax.—Under the bill, the additional income tax on withdrawals from an IRA by the owner prior to attainment of age 59-1/2, death, or disability is extended to early withdrawals by any participant from any qualified retirement plan. Under the bill, the term "qualified retirement plan" includes a qualified defined benefit or defined contribution plan, or an individual retirement arrangement, including a simplified employee pension ("SEP").

With two exceptions, the amount of the tax is increased from 10 to 15 percent for distributions from all qualified retirement plans and IRAs. In the case of (a) the distribution of income attributable to after-tax employee contributions to a qualified plan, and (b) withdrawals of income attributable to nondeductible IRA contributions, the amount of the tax is 10 percent of the amount of the distribution includible in income. For purposes of this rule, employer matching contributions attributable to after-tax employee contributions, and the income on those matching contributions, are treated as income attributable to after-tax employee contributions. To ensure that the 10-percent exceptions are not inappropriately used, separate accounting will be required to identify the amounts eligi-

ble for the 10-percent rule, such as in the case of rollovers or transfers.

Exemptions.—The bill exempts from the additional income tax on early withdrawals (1) any distribution that is part of a scheduled series of substantially equal periodic payments for the life of the participant (or the joint lives of the participant and the participant's beneficiary), (2) any distribution to an employee (other than a 5-percent owner) who has attained age 55, separated from service, and satisfied the requirements for early retirement under the plan, (3) certain hardship distributions, and (4) certain distributions from an employee stock ownership plan.

An exemption from the tax is provided for any distribution that is part of a scheduled series of substantially equal periodic payments (made not less frequently than annually) for the life of the participant (or the joint lives of the participant and the participant's beneficiary). For example, distributions under a life annuity to a 50-year-old participant under a qualified plan under which normal retirement occurs after 30 years of service is exempt from the additional 15 percent income tax. Similarly, distributions under an annuity providing substantially equal periodic payments for the life of the participant or a term certain, whichever is longer, will be exempt from the additional tax.

The committee intends that, in the case of a defined contribution plan or IRA, the exemption from the tax is to be available if the plan or IRA purchases a commercial annuity to fund the individual's benefit or, alternatively, if the plan or IRA distributes the individual's account in substantially equal payments over the life expectancy of the participant or the joint life expectancies of the participant and the participant's beneficiary. A series of payments under a defined contribution or defined benefit plan will not fail to be substantially equal solely because the payments vary on account of (1) certain cost of living adjustments, (2) cash refunds of employee contributions upon an employee's death, (3) a benefit increase provided to retired employees, (4) an adjustment due to the death of the employee's beneficiary, or (5) the cessation of a social security supplement. The committee intends that the Secretary may prescribe regulations setting forth other factors (consistent with the factors prescribed under sec. 401(a)(9)) that will not cause payments to fail to be considered substantially equal.

In the event an individual commences receiving distributions prior to attaining age 59½ in a form that is exempt from the additional income tax, if the payment of the individual's benefits is later changed (prior to the date that the individual attains age 59½) to a form that does not satisfy the conditions for the exemption, the bill authorizes the Secretary of the Treasury to impose the 5 percent excise tax on all distributions under the contract received by the individual prior to age 59½.

The bill also exempts from the tax a distribution from a qualified plan to an employee (other than 5-percent owners) on or after the date that the individual attains the age of 55, separates from service, and satisfies the conditions for early retirement specified under the plan. The exemption does not apply to distributions from an individual retirement account or annuity. If a plan does not specify an early retirement age (including a defined contribution plan that

otherwise makes distributions upon separation from service), the exception to the tax is not available.

Also exempted from the tax are distributions from qualified plans to an employee (other than 5-percent owners) on account of certain unforeseen hardships. Unforeseen hardships that qualify for the exemption include only (1) medical expenses, to the extent that such expenses would be deductible under section 213 if 5 percent were substituted for 10 percent in that section; (2) casualty losses, to the extent that such expenses would be deductible under section 165 if 5 percent were substituted for 10 percent in that section; and (3) in the case of an individual who is involuntarily terminated from employment, amounts necessary to replace unemployment benefits paid under a program upon their cessation (for so long as the individual remains unemployed). A distribution on account of an unforeseen hadship is exempt from the tax only to the extent that any distribution, other than any distibutions for the year that were exempt from the tax (because paid on account of early retirement or in substantially equal payments over the life of the individual) do not exceed the taxpayer's aggregate hardship expenses for the yar.

The exemption for distributions on account of unforeseen hardships is unavailable for distributions from an individual retirement account.

An individual is treated as a 5-percent owner, for purposes of the exemptions that are unavailable to 5-percent owners, if the individual is a 5-percent owner (within the meaning of sec. 416(i)) in the plan year in which the distribution is received or in any of the preceding 4 plan years.

Finally, the bill also exempts from the additional income tax on prematue withdrawals, certain distibutions from an employee stock ownership plan to the extent that, on average, a majority of the assets in the plan have been invested in employer securities, as defined in section 409(l) for five years immediately preceding such distribution.

In a case in which an ESOP has been in existence for less than five years, the plan must have been so invested during the entirety of the period prior to distribution. In a case in which a plan is converted to an ESOP, plan assets must have been so invested for five years prior to distribution. Amounts rolled over or transferred to an ESOP from other qualified plans generally will not qualify for this exception from the early withdrawal tax: (a) unless, on average, a majority of such amounts were invested in employer securities for five years prior to such transfer (or, if shorter, during such period as the plan was in existence), or (b) until such time as, on average, a majority of such amounts have been invested in employer securities in an ESOP for five years. Tacking periods would be permitted. For example, amounts transferred to an ESOP would qualify for the exception three years after transfer provided such amounts meet the investment criteria for two years after such transfer provided such amounts meet the investment criteria for two years prior to such transfer. In addition, amounts transferred to an ESOP from a terminated defined benefit pension plan would qualify for this exception provided a majority of such amounts are invested in employer securities upon transfer and the 5 year hold-

ing requirement is met. The committee intends that a first-in, first-out rule be used for purposes of determining the length of time a plan has held securities distributed to a participant.

Direct transfer option

In addition, in the case of an employee who separates from service and is to receive a distribution that could be rolled over to another qualified plan or IRA, the employer is required to offer the employee the option of electing a direct transfer of the employee's accrued benefit to an IRA or to another qualified plan. The employee would be entitled to make the election only if the employee supplied the employer with sufficient information to effect the transfer.

In addition, the bill requires that the notice of rollover treatment that a plan administrator is required to provide to a participant when the plan makes a qualifying rollover distribution is to be revised to include a statement that the employee's distribution may be subject to an additional 15-percent income tax if not rolled over to an IRA or to another qualified plan.

Effective Dates

The provisions generally are effective for years beginning after December 31, 1986. The provision permitting distributions from a qualified cash or deferred arrangement and from an ESOP upon plan termination applies to plan terminations after December 31, 1984. The provision permitting distributions from a qualified cash or deferred arrangement in connection with the sale of a subsidiary are effective for sales in years beginning after December 31, 1986. The provision restricting hardship distributions from a qualified cash or deferred arrangement is effective for years beginning after December 31, 1988.

The provisions relating to the additional income tax on early withdrawals apply to all distributions made in taxable years beginning after December 31, 1986. However, the bill contains an exception from the tax for individuals who, as of March 1, 1986, separated from service and commenced receiving benefits pursuant to a written election designating a specific schedule of benefit payments. In addition, if the participant failed to make a written election, the requirement that benefits be paid pursuant to a written election designating a specific schedule of benefit payments for the distribution of the entire accrued benefit of the participant will be deemed satisfied where the plan from which the benefits are paid provides for only one form of distribution, or where (1) the plan provides that, in the absence of an election to the contrary, a participant will be paid benefits according to the automatic form of payment specified in the plan, and (2) the individual is, in fact, receiving benefits in that form.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $47 million in 1987, $158 million in 1988, $295 million in 1989, $411 million in 1990, and $550 million in 1991.

4. Treatment of Loans (sec. 1233 of the bill and sec. 72 the Code)

Present Law

An individual is permitted, under present law, to borrow from a qualified plan in which the individual participates (and to use his or her accrued benefit as security for the loan) provided the loan bears a reasonable rate of interest, is adequately secured, provides a reasonable repayment schedule, and is not made available on a basis that discriminates in favor of employees who are officers, shareholders, or highly compensated (sec. 4975). However, no loan is permitted under the Employee Retirement Income Security Act of 1974 (ERISA) or the Code from a qualified plan to an owner-employee (i.e., a sole proprietor or more than 10-percent partner).

Subject to certain exceptions, a loan to a plan participant is treated as a taxable distribution of plan benefits. An exception to this general rule of income inclusion is provided to the extent that the loan (when added to the outstanding balance of all other loans to the participant from all plans maintained by the employer) does not exceed the lesser of (1) $50,000 or (2) the greater of $10,000 or one-half of the participant's accrued benefit under the plan. This exception applies only if the loan must, by its terms, be repaid within five years or, if the loan is used to acquire or improve a principal residence of the participant or a member of the participant's family, within a reasonable period of time.

Reasons for Change

The rules governing the tax treatment of loans from certain tax-favored plans are intended to limit the extent to which an employee may currently use assets held by a plan for nonretirement purposes and to ensure that loans are actually repaid within a reasonable period. However, there is concern that the present rules may not prevent an employee from effectively maintaining a permanent outstanding $50,000 loan balance through the use of balloon repayment obligations and bridge loans from third parties.

In addition, the present law rule permitting home loans with repayment periods extending beyond five years for certain improvements on existing principal residences is overly broad and difficult to apply. The committee believes that the favorable tax treatment of amounts set aside in qualified plans should be targeted at providing employees with retirement income security, and that any exceptions to this general policy should be narrowly limited.

Explanation of Provision

The bill modifies the exception to the income inclusion rule by reducing the $50,000 limit on a loan by the participant's highest outstanding loan balance during the preceding 12-month period.

In addition, the extended repayment period permitted for purchase or improvement of a principal residence is amended to apply only to the purchase of the principal residence of the participant or a lineal descendant of the participant. Thus, for example, plan loans to improve an existing principal residence, or to purchase a second home are subject to the 5-year repayment rule.

Because of the limitations on the deductibility of consumer interest contained in the bill, in many instances the interest paid on

loans from qualified plans will be nondeductible. The committee notes that nondeductible interest payments to a plan do not constitute basis in the plan.

Effective Date

The provisions would be effective for amounts received as a loan after December 31, 1986. Any renegotiation, extension, renewal, or revision after December 31, 1986, of an existing loan is treated as a new loan on the date of such renegotiation, etc.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by less than $5 million annually.

D. Limits on Tax Deferral Under Qualified Plans

1. Adjustments to Limitations on Contributions and Benefits Under Qualified Plans (sec. 1206 of the bill, sec. 415 of the Code)

Present Law

In general

Present law (sec. 415) provides overall limits on contributions and benefits under qualified pension, profit-sharing, and stock bonus plans, qualified annuity plans, tax-sheltered annuities, and simplified employee pensions (SEPs). The overall limits apply to contributions and benefits provided to an individual under all qualified plans, tax-sheltered annuities, and SEPs maintained by any private or public employer or by certain related employers.

Defined contribution plans

Dollar limit

Under a defined contribution plan,[1] the qualification rules provide a limit on the annual additions with respect to each plan participant (sec. 415(c)).[2] Under present law, the annual addition on behalf of an employee generally is limited to the lesser of (1) 25 percent of compensation for the year, or (2) $30,000. Beginning in 1988, the dollar limit is to be adjusted for post-1986 cost-of-living increases.

Under present law, special increased limits (i.e., special catch up elections) are provided for employees of certain employers eligible to participate in tax-sheltered annuities.

Annual addition

Under present law, annual additions (sec. 415(c)) include employer contributions, forfeitures, certain employee contributions, and certain contributions for post-retirement medical benefits. The amount of nondeductible employee contributions taken into account as annual additions is the lesser of (1) one-half of the employee contributions, or (2) total employee contributions in excess of six percent of compensation.[3] Therefore, if total employee contributions do not exceed six percent of compensation, no employee contributions are counted as annual additions. In addition, under

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[1] A defined contribution plan is one under which each participant's benefit is based solely on the balance of the participant's account consisting of contributions, income, gain, expenses, losses, and forfeitures allocated from the accounts of other participants.

[2] For purposes of applying this limit, all defined contribution plans of an employer are treated as a single plan.

[3] Deductible employee contributions are not included in the definition of annual additions, but are instead coordinated with the individual's deductible IRA contributions.

present law, certain amounts having the effect of employer contributions may be treated as annual additions.

Defined benefit pension plans

Under present law, the limit on the annual benefit payable from a defined benefit pension plan[4] is the lesser of (1) 100 percent of average compensation, or (2) $90,000.[5] Beginning in 1988, the dollar limit is to be adjusted to reflect post-1986 cost-of-living increases. The annual benefit generally is the equivalent of an annuity for the life of the participant, beginning at normal retirement age (generally, age 62 or later), and determined without regard to certain survivor and nonretirement benefits.

Early retirement benefits

If retirement benefits commence before age 62, the dollar limit (but not the 100 percent of compensation limit) is reduced. Thus, for benefits commencing before age 62, the $90,000 limit generally is reduced so that it is the actuarial equivalent of an annual benefit of $90,000 commencing at age 62. In no event, however, is the dollar limit applicable to benefits commencing at or after age 55 less than $75,000. If retirement benefits commence before age 55, the dollar limit is actuarially reduced so that it is the greater of (1) the actuarial equivalent of a $75,000 annual benefit commencing at age 55, or (2) the actuarial equivalent of the applicable dollar limit at age 62. The $75,000 early retirement safe harbor is not adjusted for cost-of-living or wage increases and, therefore, will have no effect after the $90,000 overall limit on annual benefts is adjusted for cost-of-living increases to an amount at age 62 that is actuarially equivalent to an annual benefit of $75,000 at age 55.

Under present law, the reduction in the dollar limit for benefits commencing before age 62, and the reduction in the $75,000 amount for benefits commencing before age 55, must be computed using an interest rate assumption not less than the greater of five percent or the rate specified in the plan for purposes of determining benefits payable before the normal retirement age. There is no required reduction for pre-retirement ancillary benefits (such as medical, death, or disability benefits), but adjustments are required to reflect post-retirement ancillary benefits such as term-certain annuities, post-retirement death benefits, etc.

If retirement benefits under a defined benefit plan begin after age 65, the $90,000 limit is increased so that it is the actuarial equivalent of an annual benefit of $90,000 beginning at age 65. The increase is to be computed using an interest rate assumption not greater than the lesser of five percent or the rate specified in the plan.

These provisions do not prohibit an employee from retiring prior to age 62, and they do not mandate actuarial reductions in plan benefits commencing prior to age 62 where the limits are not ex-

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[4] A defined benefit pension plan specifies a participant's benefit independently of an account for contributions, and other amounts. For example, a defined benefit plan may provide an annual benefit of two percent of average pay for each year of employee service.

[5] For purposes of applying this limit, all defined benefit plans of an employer are treated as a single plan.

ceeded. Similarly, present law does not require that a plan provide increased benefits for participants retiring after age 65.

Eligibility to receive maximum benefits

Under present law, the limits on benefits are phased in for participants with less than ten years of service. Both the dollar and percentage limits are reduced by ten percent per year for each year of service less than ten. For example, benefits commencing at or after age 62 with respect to a participant who had only three years of service generally could not exceed the lesser of 30 percent of compensation (3/10 times 100 percent of average compensation), or $27,000 ($27,000 is 3/10 of the present-law $90,000 dollar limit).

A special de minimis rule, which generally permits payment of annual benefits not in excess of $10,000 for participants who have not at any time participated in a defined contribution plan maintained by the employer, similarly is reduced for participants with less than 10 years of service. For example, the de minimis benefit payable with respect to a participant who had only three years of service could not exceed $3,000 (3/10 of $10,000).

Cost-of-living increases

Beginning in 1988, the $30,000 and $90,000 limits are scheduled to be adjusted for post-1986 cost-of-living increases. Under present law, these dollar limits are adjusted in the same manner as the adjustments to the Primary Insurance Amounts under social security, which generally are adjusted by the percentage increases in the Consumer Price Index.

Includible compensation

Under present law, under certain plans, a limit is provided for the amount of any participant's compensation that is taken into account under the plan. In the case of a top-heavy plan or a simplified employee pension (SEP), the limit on includible compensation is $200,000 (adjusted at the same time and in the same manner as the adjustments to the dollar limit on annual additions under a defined contribution plan). This limit on includible compensation applies for purposes of determining (1) the dollar limits on contributions and benefits, and (2) whether a plan meets the nondiscrimination requirements (secs. 401(a)(4) and 408(k)(3)).

Reasons for Change

Although the code provides tax incentives to encourage employer-provided retirement benefits, it also limits the tax-favored retirement savings of an employee under qualified plans of a particular employer. In evaluating these incentives, the committee concluded that the current dollar limits ($30,000 and $90,000, respectively) should be adjusted in a manner that is more closely tied to the social security system.

The committee is concerned that present law tends to encourage early retirement because the dollar limitations on benefits are more generous for individuals who retire before the social security retirement age (presently, age 65) than the limits for individuals who retire on or after the social security retirement age because of

the manner in which the dollar limits are actuarially reduced for early retirement.

In considering the dollar limits, the committee focused not only on the dollar amounts appropriate for the separate plan limits, but also on the relative attractiveness of defined contribution and defined benefit plans, and the appropriateness of the present-law adjustments for cost-of-living.

The committee concluded that defined benefit pension plans generally provide better overall retirement income security because the participants in such plans are protected against bad investment experience and because many plans may provide protection against inflation up to normal retirement age (because the benefits provided are often based on final average pay). In addition, defined benefit plans are regarded as more reliable in achieving an intended income replacement goal. Accordingly, the committee found it appropriate to provide for a gradual change in the ratio between the defined benefit and defined contribution limits.

In addition, the committee is concerned that the rule requiring reduced limits on benefits payable to participants with fewer than ten years of service is not effectively limiting benefits for highly compensated employees with short periods of plan participation. The committee is aware that some employers are able to plan the timing of the establishment of a defined benefit plan (or an increase in benefits under a pre-existing plan) to coincide with projected retirement of one or more of the employer's highly compensated employees. The effect of this delay is to avoid providing a comparable level of benefits to other employees who may have retired before the highly compensated employees. If, on the other hand, the defined benefit pension plan was established earlier so that the highly compensated employees accrued the maximum benefit over a longer period of service, rank-and-file employees would have accrued (and become vested in) greater benefits. Thus, the committee finds it appropriate to require ten years of participation in a defined benefit pension plan before the maximum benefits can be provided.

Explanation of Provisions

Overview

The bill makes several changes to the overall limits on contributions and benefits under qualified plans, tax-sheltered annuity programs, and SEPs of private and public employers.

The normal retirement age for purposes of the limit on benefits under a defined benefit pension plan is conformed to the social security retirement age. If the retirement benefit under a defined benefit plan begins before the social security retirement age (presently, age 65), then the $90,000 limitation on annual benefits generally is reduced so that it is the actuarial equivalent of an annual benefit of $90,000 beginning at the social security retirement age. Under transition rules provided by the bill, benefits already accrued by a plan participant under an existing plan are not affected by the reductions for actuarial equivalence.

Although cost-of-living adjustments will be made to the defined benefit plan limit beginning in 1988, no cost-of-living adjustments

to the defined contribution plan limit will be made until the $30,000 limit is equal to 25 percent of the defined benefit dollar limit, at which point the defined contribution plan limit will be increased to maintain the 25-percent ratio. Finally, the method of indexing the dollar limits is modified.

Under the bill, the class of employers whose employees are entitled to the special catch-up elections under section 415 is expanded to include employers that are health and welfare service agencies.

Defined benefit pension plans

Dollar limits on benefits adjusted to conform to social security retirement age

Under the bill, if retirement benefits under a defined benefit plan begin before the social security retirement age, the $90,000 limit (but not the 100 percent of compensation limit) generally is to be reduced so that it is the actuarial equivalent of an annual benefit of $90,000 beginning at the social security retirement age (65 for 1986). In addition, the bill repeals the special rule for early retirement under which the dollar limit for benefits commencing at or after age 55 is not reduced below $75,000. Thus, the dollar limit for benefits which commence at any age before the social security retirement age will be the actuarial equivalent of the inflation-adjusted dollar limit ($90,000 for 1986) for benefits commencing at the social security retirement age.

Under present law, the social security retirement age is phased up to age 67 from age 65 over 20 years and the social security retirement age with respect to any individual may be age 65 or 66 plus a fraction of a year depending upon when the individual attains the social security early retirement age (age 62). Under the bill, this phase up to age 67 is modified so that employers will not be required to determine the number of months included in the phase up with respect to each plan participant. The bill provides that, in calculating the social security retirement age for participants, the age increase factor is ignored. Thus, the following method is to be used to determine the social security retirement age of a plan participant during the phase up period: (1) in the case of a plan participant who attains age 62 before January 1, 2000, age 65; (2) in the case of a plan participant who attains age 62 after December 31, 1999, and before January 1, 2017, age 66; and (3) in the case of a plan participant who attains age 62 after December 31, 2016, age 67.

Under the bill, the adjustment of the dollar limitation on benefits with respect to a participant who retires at or after age 62 and before the social security retirement age is to be done in a manner consistent with the reduction for early retirement benefits under social security. The reduction for early retirement will equal, under the bill, 5/9 of 1 percent for each month the individual is under age 65 at retirement. This reduction produces a benefit equal, at age 62, to 80 percent of the benefit otherwise payable if the individual had retired at age 65. When the social security retirement age begins to phase up, the reduction will continue to be 5/9 of 1 percent for the first 36 months of early retirement plus 5/12 of 1 percent for each additional month of early retirement at or

after age 62. Therefore, if an individual retires at age 62 when the social security retirement age is 67, the benefit at age 62 will equal 70 percent of the benefit otherwise payable at social security retirement age. Benefits commencing prior to age 62 will be reduced to reflect the actuarial equivalent of the benefit payable at age 62. As under present law, the reduction is to be computed using an interest rate assumption not less than the greater of 5 percent or the rate specified in the plan for purposes of determining early retirement benefits.

The provisions of the bill conforming normal retirement age under a plan to the social security retirement age and providing an early retirement reduction consistent with the social security reduction for early retirement applies for purposes of the dollar limit on benefits under a defined benefit plan and for purposes of determining the employer's deduction for funding of such benefits. The provisions do not affect in any way either the time at which plan participants may retire or the employer's assumption (for funding purposes) with respect to the time at which participants will retire. In addition, the provisions apply only to individuals whose benefits exceed the dollar limits on benefits and, thus, do not require an actuarial reduction for early retirement benefits for all participants whose benefits commence before the social security retirement age.

The bill also modifies the present-law rule permitting an increased limit with respect to benefits commencing after attainment of age 65. Accordingly, under the bill, if retirement benefits under a defined benefit plan begin after the social security retirement age, the dollar limit is increased so that it is the actuarial equivalent of an annual benefit of $90,000 beginning at the social security retirement age. As under present law, the increase is to be computed using an interest rate assumption not higher than the lesser of five percent or the rate specified in the plan.

Special rules for airline pilots, police, and firefighters, and correctional officers

The bill provides special rules for commercial airline pilots, participants in a qualified police or firefighters' pension plan, and for certain correctional officers.

Federal regulations require that commercial airline pilots retire after attaining age 60. The committee believes that it is inappropriate to require actuarial reduction in the dollar limit on benefits payable under these circumstances. Accordingly, under the bill, the reduction for early retirement does not apply to airline pilots whose benefit payments commence at or after age 60 and provides that the dollar limit applicable to annual benefits beginning at age 60 is $90,000 (adjusted for cost-of-living increases).

Similarly, the committee believes it is inappropriate to provide full actuarial reduction of the limit on benefits payable to participants in a qualified police or firefighters' pension plan, or benefits provided for certain correctional officers. The bill provides that the dollar limit on benefits payable to participants in a qualified police or firefighters' pension plan or benefits provided to such correctional officers will never be actuarially reduced to an amount less than $50,000, regardless of the age at which the benefits commence. Further, the provisions in the bill conforming the retirement age for

purposes of the limits on benefits to the social security retirement age and modifying the actuarial reductions for early retirement do not apply to such plans or to benefits provided to such officers.

For purposes of this provision, a qualified police or firefighters' pension plan is defined as a defined benefit plan maintained by a State (or political subdivision thereof) for the benefit of all full-time employees of any police or fire department organized and operated by such State or political subdivision to provide police protection, fire-fighting services, or emergency medical care. In addition, a qualified police or firefighters' pension plan is required to (1) limit service taken into account to service with a police or fire department (or the armed services of the United States); and (2) require, as a condition to the payment of benefits, at least 20 years of service.

The bill provides treatment similar to the treatment of participants in a qualified police or firefighters' plan to correctional officers. Under the bill, the term correctional officers means an individual who (1) is an employee of a State or political subdivision whose primary duties include the care, custody, instruction, or transportation of prisoners or inmates, and (2) is a participant in a plan that meets requirements similar to the requirements for a qualified police or firefighters' plan. Under the bill, the plan in which correctional officers participate is not required to be a plan maintained solely for such correctional officers, but may include other employees of the State or political subdivision.

Qualified cost-of-living arrangement

In general

The bill also permits a defined benefit pension plan to maintain a qualified cost-of-living arrangement under which employer and employee contributions may be applied to provide cost-of-living increases to the primary benefit. A qualified cost-of-living arrangement is defined as an arrangement under a defined benefit plan that complies with the limits, election procedures, and nondiscrimination requirements of the bill, as well as such other requirements as the Secretary of the Treasury may prescribe.

Of course, a qualified cost-of-living arrangement must satisfy all of the applicable qualification requirements of section 401(a) not specifically altered or made inapplicable by the bill. For example, the right to the employer-provided portion of a cost-of-living benefit under a qualified arrangement is part of the accrued benefit subject to section 411 (including section 411(d)(6)) and thus will accrue and vest as the employee accrues and vests in the normal retirement benefit. Thus, an employer may reduce or eliminate the employer contribution under a qualified cost-of-living arrangement only with respect to benefits not yet accrued.

Similarly, such cost-of-living increases must be available on the same terms for all participants. Thus, a greater subsidy could not be provided for employees who work until retirement than to those who separate from service with vested benefits prior to retirement.

A qualified cost-of-living arrangement satisfies the limit requirement added by the bill if it (1) limits cost-of-living adjustments to those increases occurring after the annuity starting date, and (2)

bases the cost-of-living adjustment on average cost-of-living increases determined by reference to one or more indexes prescribed by the Secretary (or the plan can provide a minimum increase for each year of three percent).

A cost-of-living arrangement meets the election requirements added by the bill if it provides that participation in the qualified cost-of-living arrangement is elective and permits participants to make an election (1) in the year in which the participant attains the age at which retirement benefits are first available under the defined benefit plan, or separates from service, or (2) in both such years.

A cost-of-living arrangement meets the nondiscrimination rules added by the bill only if the arrangement does not discriminate in favor of highly compensated employees as to eligibility to participate.

Special rule for key employees

Under the bill, key employees generally are precluded from participating in a qualified cost-of-living arrangement. However, in a plan that is not top heavy, officers who are key employees solely by reason of their status as officers may participate. For purposes of this rule, key employee has the same meaning as it does for top-heavy plans (sec. 416(i)).

Treatment of contributions to qualified cost-of-living arrangements

Under the bill, any employee contribution made to a qualified cost-of-living arrangement will not be treated as an annual addition for purposes of the annual limit (sec. 415(c), but will be treated as an annual addition for purposes of applying the combined plan limit (sec. 415(e)). Any benefit under a qualified cost-of-living arrangement that is allocable to an employer contribution that was transferred from a defined contribution plan to which section 415(c) applied is treated as a benefit derived from an employee contribution for purposes of section 415(b), and neither section 415(e) nor (c) apply to such contribution by reason of the transfer.

Employee contributions to a qualified cost-of-living arrangement are subject to the nondiscrimination rules generally applicable to employee contributions (secs. 401(a)(4) and 401(m)).

Treatment of employee contributions as annual additions

The bill repeals the treatment of employee contributions under present law and provides that all employee contributions, rather than a portion of employee contributions, are included in the annual addition for purposes of the dollar limits on contributions under a defined contribution plan.

Eligibility to receive maximum benefits

Under the bill, reduced limits apply to participants with fewer than 10 years of participation in a defined benefit pension plan (sec. 415(b)(5)). The dollar limit on benefits payable from a defined benefit pension plan (but not the percentage of compensation limit) generally is reduced by ten percent per year for each year of participation in the plan less than 10. In no event, however, is the

limit reduced to an amount less than one-tenth of the dollar limit ($9,000). Thus, service with the employer prior to becoming a participant under the plan is disregarded in determining the dollar limit on benefits payable under the plan. For example, if a participant who would otherwise be entitled under the terms of the plan to receive the maximum annual benefit had only three years of participation in the plan, the maximum benefit payable would be the lesser of 100 percent of compensation (reduced by 10 percent for each year of service less than 10), or $27,000 (3/10ths of $90,000).

Except as provided by the Secretary of the Treasury, a new ten-year period of participation will be required with respect to increases in the otherwise applicable limit made available through changes in the benefit structure (whether made by plan amendment or otherwise). In general, no participant will be entitled to the full amount of the increased limit until the participant completes ten years of participation after the change in benefit structure. The Secretary of the Treasury is to prescribe regulations defining those changes in benefit structure for which a new ten-year period of participation would not be required. The committee generally does not intend plan provisions that merely incorporate cost-of-living increases (within the meaning of section 415(d)) or compensation changes (as in a final pay plan) to be treated as changes in benefit structure requiring an additional ten years of participation. In addition, the bill authorizes the Secretary of the Treasury to issue regulations for the application of this rule in situations involving plan mergers or spin-offs.

The bill retains the present-law provision that phases in the percentage of compensation limit (sec. 415(b)(1)(B)), and the special $10,000 de minimis benefit based on years of service.

Includible compensation

The bill provides a limit on the amount of compensation that may be taken into account under any plan. The $200,000 limit presently applicable to top-heavy plans and SEPs is applied to all qualified plans, whether or not top-heavy (sec. 401(a)(17)). The limit on includible compensation will be increased at the same time and in the same manner as the dollar limits on benefits under a defined benefit plan. This limit applies for most purposes, including the provisions relating to nondiscrimination (e.g., secs. 401(a)(4), 401(a)(5), 401(k)(3), 401(l), 401(m), 408(k)).

The committee intends that the Secretary shall prescribe such rules as will effectuate the intent of the $200,000 limit. The purpose of the limitation is to ensure that reductions in the maximum contributions or benefits do not reduce the contributions or benefits of low- and middle-income employees. It is inconsistent with this intent to define compensation in such a manner that the $200,000 limit has little effect on highly compensated employees, but the compensation definition adversely impacts low- and middle-income employees.

Cost-of-living adjustments

The bill retains the present-law cost-of-living adjustments for the defined benefit plan dollar limit (sec. 415(d)), but modifies the

manner in which such adjustments are calculated. Under the bill, the dollar limits on benefits are adjusted (beginning in 1988) for the percentage increases in the taxable wage base under social security. Rather than being adjusted for increases in the Consumer Price Index (as under present law), the defined benefit pension dollar limit is adjusted for increases both in wages and in prices, which is projected to result in a greater increase in the dollar limits than the present-law method would produce. However, under the bill, cost-of-living adjustments to the $30,000 defined contribution plan dollar limit will be temporarily suspended until that limit is equal to 25 percent of the defined benefit plan dollar limit. Thereafter, cost-of-living adjustments will be provided, effectively ensuring that the defined contribution plan dollar limit will be equal to the greater of $30,000 or 25 percent of the defined benefit plan limit.

As under present law, anticipated cost-of-living adjustments to the overall benefit limits may not be taken into account under the rules relating to the deduction allowed for employer contributions to a qualified plan.

The committee intends that, if the social security wage base is modified by Congress (e.g., by an amendment halving or doubling the current taxable wage base or altering the indexing method), that such independent action is not to affect the indexing method for qualified plans.

Effective Dates

In general

The provisions generally apply to years beginning after December 31, 1986. Under the bill, a plan will not fail to be qualified for any year beginning before January 1, 1989, merely because the plan is not amended to provide that benefits or contributions will not exceed the limits under the bill. However, employer deductions with respect to years beginning after December 31, 1986, are limited to those amounts required to fund the limits provided by the bill (whether or not contributions required by the plan document exceed those limits). In addition, no later than the first plan year beginning after December 31, 1988, the plan is to be amended to provide that benefits in excess of the limits (other than benefits grandfathered under the transition rule below) are reduced to conform to the limits as amended.

The bill provides a special effective date for plans maintained pursuant to one or more collective bargaining agreements ratified before March 1, 1986, between employee representatives and one or more employers. Under the bill, the new limits on benefits and contributions will not apply to years beginning before the earlier of (i) the date on which the last of the collective bargaining agreements terminates, or (ii) January 1, 1991. For this purpose, any extension of the collective bargaining agreement agreed to after February 28, 1986, will be disregarded. In addition, any plan amendment that amends the plan solely to conform to the amendments made by the bill (with respect to benefit limits and distribution requirements) will not be considered a termination or extension of the collective bargaining agreement.

Transitional rules relating to current accrued benefits

The bill also provides a transition rule to ensure that a participant's previously accrued benefit under a defined benefit pension plan is not reduced merely because the bill reduces the dollar limits on benefits payable under the plan or increases the period of participation required to earn the maximum benefit. This rule applies with respect to an individual who is a participant before January 1, 1987, in a plan that was in existence on May 6, 1986. If such an individual has a current accrued benefit that exceeds the dollar limit permitted under the bill (but does not exceed the dollar limit in effect under prior law), then the applicable dollar limit for the individual is equal to that current accrued benefit. Similarly, in computing the participant's defined benefit fraction, the current accrued benefit would replace the dollar limit otherwise used in the denominator of the fraction.

Under the bill, an individual's current accrued benefit is defined as the individual's accrued benefit as of the close of the last year beginning before January 1, 1987, expressed as an annual benefit determined pursuant to the rules in effect prior to the amendments made by the bill.

For purposes of determining an individual's current accrued benefit, no change in the terms and conditions of the plan after May 6, 1986, is taken into account. Accordingly, if an individual's current accrued benefit is a specified percentage of average pay, rather than a specified amount, the current accrued benefit is the specified percentage of the average pay computed as of the close of the last year beginning before 1987, based upon compensation paid up to that time (without regard to compensation advances). Although subsequent salary increases might increase the benefit to which a participant is entitled under the plan, those increases would not increase the participant's current accrued benefit. Similarly, cost-of-living adjustments occurring after 1986 are not taken into account in computing the current accrued benefit. In addition, with respect to an individual whose annual benefit is treated as not exceeding the annual benefit limit (sec. 415(b)) on account of the transitional rule provided by section 2004(d)(2) of the Employee Retirement Income Security Act of 1974, or section 237(g) of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), the individual's accrued benefit is the individual's annual benefit or the current accrued benefit as defined therein.

The bill does not affect the obligation of a plan to provide the current accrued benefit and the bill does not affect the consequences of an employer's failure to fund an individual's current accrued benefit. However, benefits accruing in years beginning after December 31, 1986, are not protected by this transition rule. Consistent with changes made by the Retirement Equity Act of 1984, the committee intends that the Secretary may prescribe rules under which such reductions to conform the plan to the limits, as amended, will not be considered a violation of the rules precluding a reduction in accrued benefits (sec. 411(d)(6)) as long as the amount of the reduction does not exceed the amount required to bring the plan into compliance with the bill. Thereafter, no further accruals will be permitted for an individual whose current accrued

benefit exceeds the bill's usual dollar limit until that dollar limit, as adjusted for cost-of-living increases, exceeds the individual's current accrued benefit.

With respect to a plan maintained pursuant to one or more collective bargaining agreements ratified before May 6, 1986, the current accrued benefit of an individual is the individual's accrued benefit as of the close of the last year beginning before the earlier of (1) the date on which the last of the collective bargaining agreements terminates, or (2) January 1, 1991.

Employee contributions treated as annual additions

The provision treating all employee contributions as annual additions generally is effective for years beginning after December 31, 1986. However, for purposes of calculating the defined contribution plan fraction and applying the combined plan limit (sec. 415(e)), the present-law rules will still apply in calculating the fraction applicable to years beginning before January 1, 1987. Thus, the defined contribution plan fraction applicable to years beginning before January 1, 1987, need not be recalculated to conform to the new definition of annual additions.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $315 million in 1987, $869 million in 1988, $960 million in 1989, $1,097 million in 1990, and $1,259 million in 1991.

2. Adjustments to Section 404 Limitations (sec. 1231 of the bill and secs. 404 and 4972 of the Code)

Present Law

In general

The contributions of an employer to a qualified plan are deductible in the year for which the contributions are paid, within limits (sec. 404). No deduction is allowed, however, for a contribution that is not an ordinary and necessary business expense or an expense for the production of income. The deduction limits applicable to an employer's contribution depend on the type of plan to which the contribution is made and may depend on whether an employee covered by the plan is also covered by another plan of the employer. Under present law, if a contribution for a year exceeds the deduction limits, then the excess generally may be deducted in succeeding years as a carryover. However, no deduction is allowed with respect to contributions or benefits in excess of the overall limits on contributions or benefits (sec. 404(j)).

Profit-sharing and stock bonus plans

In the case of a qualified profit-sharing or stock bonus plan, employer contributions for a year not in excess of 15 percent of the aggregate compensation of covered employees are generally deductible for the year paid (sec. 404(a)(3)). If employer contributions for a group of employees for a particular year exceed the deduction limits, then the excess may be carried over and deducted in later years (within limits). If, however, the contribution for a particular

year is less than the maximum amount for which a deduction is allowed, then the unused limitation (i.e., the limit carryforward) may be carried over and used in later years. In the case of a limit carryforward, the total amount that may be deducted in a later year may not exceed 25 percent of the aggregate compensation of employees covered by the plan during that year.

Defined benefit pension plans

In general

Employer contributions under a defined benefit pension plan are required to meet a minimum funding standard (sec. 412). The deduction allowed for an employer's contribution to a defined benefit pension plan is limited to the greatest of the following amounts:

(1) The amount necessary to meet the minimum funding standard for plan years ending with or within the taxable year.[6]

(2) The level amount (or percentage of compensation) necessary to provide for the remaining unfunded cost of the past and current service credits of all employees under the plan (adjusted if applicable, by a 10-year amortization of experience gains or losses) over the remaining future service of each employee. Under the Code, however, if the remaining unfunded cost with respect to any three individuals is more than 50 percent of the cost for all employees, then the cost attributable to each of those employees is spread over at least five taxable years.

(3) An amount equal to the normal cost of the plan plus, if past service or certain other credits are provided, an amount necessary to amortize those credits plus experience gains or losses in equal annual payments over 10 years (sec. 404(a)(1)).

Minimum funding

Under the minimum funding standard, the portion of the cost of a plan that is required to be paid for a particular year depends upon the nature of the cost. Each funding method allocates total costs between the "normal cost" which is generally required to be funded currently and "past service costs" which are spread over a period of years.

Carryover of certain excess contributions

The minimum funding standard includes a provision (the full funding limitation) designed to eliminate the requirement that additional employer contributions be made for a period during which the plan is fully funded. The funding standard, however, does not prohibit employers from making contributions in excess of the full funding limitation.

Employer contributions in excess of the deduction limits provided by the Code are not currently deductible. A deduction carryover is

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[6] Under the minimum funding standard, the normal cost of a plan for a year is required to be funded currently. (The normal cost of a plan for a year is the cost of benefits earned in that year.) Past service costs are required to be spread over a period of years. (The amortization period depends on the origin of the past service cost and on the funding method used by the plan.) Because the deduction limit is not less than the contribution required by the minimum funding standard, an employer is generally not required by that standard to make a nondeductible contribution. Contributions may be reduced or eliminated under a plan that has reached the full funding limitation.

generally allowed, however, for employer contributions to a qualified plan in excess of the deductible limits.

Money purchase pension plans

Employer contributions to a money purchase pension plan are generally deductible to the extent required by the minimum funding standard. Under a qualified money purchase pension plan, the amount required under the minimum funding standard is the contribution rate specified by the plan.

Combination of pension and other plans

If an employer maintains a pension plan (defined benefit or money purchase) and either a profit-sharing or a stock bonus plan for the same employee for the same year, then the employer's deduction for contributions for that year is generally limited to the greater of (1) 25 percent of the aggregate compensation of employees covered by the plans for the year, or (2) the contribution necessary to meet the minimum funding requirements of the pension plan for the year.

The limit applies, for example, if an employer maintains both a defined benefit pension plan and a profit-sharing plan for the same employee for a year. The limit does not apply, however, if the employer maintains both a defined benefit pension plan and a money purchase pension plan for the same employee for the same year because both plans are pension plans.

Reasons for Change

With respect to the 15-percent limit on annual contributions to a profit-sharing or stock bonus plan, the committee does not believe it is necessary or appropriate to provide limit carryforwards.

In addition, the committee is aware that larger deductions for plan contributions are available to an employer that maintains a defined benefit plan and a money purchase pension plan than would be allowable if the employer maintained a defined benefit plan and an annuity, profit-sharing, or stock bonus plan. Because a money purchase pension plan is a defined contribution plan under which an employee accumulates benefits in an individual account in much the same manner as in a profit-sharing or stock bonus plan, the committee believes that a combination of a money purchase pension plan and a defined benefit plan should be subject to the same overall deduction limit as a combination of defined benefit plan and an annuity, profit-sharing, or stock bonus plan.

Explanation of Provisions

Overview

The bill makes several changes to the limits on employer deductions for contributions to qualified plans. The bill (1) repeals the limit carryforward applicable to profit-sharing and stock bonus plans and (2) extends the combined plan deduction limit to any combination of a defined benefit pension plan and a money purchase pension plan.

Elimination of limit carryforward

In general

Under the bill, as under present law, the contribution of an employer to a qualified profit-sharing or stock bonus plan is generally deductible in the taxable year when paid. The employer's deduction for such a contribution generally may not exceed 15 percent of the compensation otherwise paid or accrued during the taxable year to employees who benefit under the plan.

However, the bill generally repeals limit carryforwards for a profit-sharing or stock bonus plan. Accordingly, if an employer's contribution for a particular year is less than the maximum amount for which a deduction may be allowed, the unused limit may not be carried forward to subsequent years.

The bill does not change the rules of present law relating to deduction carryforwards. Accordingly, as under present law, any amount paid into a profit-sharing or stock bonus trust in excess of the 15-percent deduction limit for the year is to be deductible in the succeeding taxable years in order of time.

Pre-1987 limitation carryforwards

The bill does not eliminate limitation carryforwards accumulated in the past. Under the bill, the deduction limit for any taxable year beginning after December 31, 1986, may be increased by the unused pre-1987 limitation carryforwards (but not to an amount in excess of 25 percent of compensation otherwise paid or accrued in that year to employees who benefit under the plan).

The bill defines the unused pre-1987 limitation carryforward applicable to any taxable year as the amount by which the 15-percent limit applicable to a profit-sharing or stock bonus plan (as in effect on the day before the date of enactment of the provision) for any taxable year beginning before January 1, 1987, exceeds the amount paid to the trust for that taxable year (to the extent the excess was not taken into account in any taxable year prior to the year for which the limit is being calculated).

Combinations of pension and other plans

The bill applies the combined plan limit of present law to any combination of defined benefit and defined contribution plans if any employee benefits under the combination of plans (sec. 404(a)(7)).

Under the bill, if an employer contributes to 1 or more qualified defined contribution plans (1 or more qualified money purchase pension plans, profit-sharing plans, or stock bonus plans) and 1 or more qualified defined benefit pension plans for a taxable year, then the amount deductible in that taxable year under the overall deduction limits applicable to the plans (sec. 404(a)(7)) is not to exceed the greater of (1) 25 percent of the compensation otherwise paid or accrued during the taxable year to the employees who benefit under the plans, or (2) the amount of contributions made to or under the defined benefit pension plan to the extent necessary to meet the minimum funding standard for that plan (sec. 412). A fully insured plan (defined in sec. 412(i)) is treated as a defined benefit pension plan for purposes of this limit.

As under present law, the otherwise applicable limits with respect to qualified pension, profit-sharing, and stock bonus plans (sec. 404(a)(1), (2) and (3)) are not reduced by the overall limit on deductions if no employee benefits under both a defined benefit pension plan and a defined contribution plan. A money purchase pension plan that amends the plan contribution formula to limit required contributions to those that are deductible will not be treated as failing to provide definitely determinable benefits. The bill makes no change to the present law provisions permitting deduction carryforwards.

Effective Date

The provisions relating to deduction limits generally apply to employer taxable years beginning after December 31, 1986. However, certain unused pre-1987 limit carryforwards are not affected by the provision generally repealing limit carryforwards.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $17 million in 1987, $42 million in 1988, $45 million in 1989, $49 million in 1990, and $54 million in 1991.

3. Excise Tax on Reversion of Qualified Plan Assets to Employer (sec. 1232 of the bill and sec. 4980 of the Code)

Present Law

A qualified plan must be for the exclusive benefit of employees (sec. 401(a)). Generally, prior to the satisfaction of all liabilities with respect to employees and their beneficiaries, the assets held under a qualified plan may not be used for, or diverted to, purposes other than the exclusive benefit of employees (sec. 401(a)(2)). However, if assets remain in a defined benefit plan upon plan termination[7] as a result of actuarial error, then after the plan has satisfied all liabilities those assets may be paid, as a reversion, to the employer.[8] Generally, a surplus is considered to be due to actuarial error if it is not due to specific action of the employer such as decreasing employer liabilities. In general, no amounts may revert to an employer upon termination of a defined contribution plan. However, certain amounts properly allocated to a suspense account under a defined contribution plan pursuant to Treasury Regulations Section 1.415-6(b)(6) may revert to the employer upon plan termination if the plan so provides.

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[7] Under present law, guidelines developed jointly by the Department of the Treasury, the Department of Labor, and the PBGC (the "Implementation Guidelines") set forth rules for certain terminations of qualified defined benefit pension plans involving reversions of excess assets.

[8] In addition, the Employee Retirement Income Security Act of 1974 (ERISA) provides that certain contributions may be returned to employers if (1) the contribution is made by mistake of fact; (2) the contribution is conditioned on initial plan qualification and the plan does not qualify; or (3) the contribution is conditioned on its deductibility and the deduction is disallowed. See Rev. Rul. 77-200, 1977-1 C.B. 98.

Reasons for Change

The committee believes that it is appropriate to limit the tax incentives available for retirement savings provided through defined benefit pension plans to the amount actually applied to provide retirement income. To the extent that amounts in such plans are not used for retirement purposes and revert to an employer, the committee believes that the tax treatment of reversions should recognize that the tax on earnings on pension funds is deferred and, thus, the benefits of this tax treatment should be recaptured. Although the committee believes that it might be possible to determine the particular year or years in which contributions resulting in a reversion arose and to recoup the resulting tax benefit attributable to a reversion on that basis, the committee is concerned that such a computation would involve undue complexity. Under the circumstances, therefore, the committee determined that a nondeductible excise tax should be imposed on reversions at a uniform rate.

However, the committee believes it is appropriate to provide an exception to this tax in the case of certain transfers of excess assets to an ESOP (to the extent that such assets are invested in employer securities) in order to encourage greater establishment of such plans to promote employee stock ownership.

Explanation of Provisions

In general

The bill imposes a 10-percent nondeductible excise tax on a reversion from a qualified plan. The tax is imposed on the person who receives the reversion.

Under the bill, the excise tax applies to a reversion from a plan (or from a trust under a plan) if the plan met the requirements of the Code for qualified status (sec. 401(a) or sec. 403(a)) at any time or if the plan was, at any time, determined to have met those requirements by the Internal Revenue Service.

Amount of reversion

The bill defines a reversion as the amount of cash and the fair market value of other property received (directly or indirectly) from a qualified plan. No inference is to be drawn from the definition of a reversion in the bill as to the income tax consequences and the effect on a plan's qualified status of a transfer of assets from a qualified plan that has not been terminated to another qualified plan.

The amount of a reversion does not include any amount distributed to any employee (or beneficiary) if such amount could have been distributed before the termination of the plan without violating the plan qualification requirements (secs. 401(a) and 403(a)). However, the provision of a benefit or other obligation that causes the disqualification of a plan (or would cause the disqualification of the plan if it were otherwise qualified) is to be taken into account as a reversion if it is provided pursuant to the termination of the plan. For example, if benefits under a plan are increased to a level in excess of the overall limits on contributions and benefits, and if

the increase is related to or in contemplation of the termination of the plan, then the value of the excess benefits is to be treated as a reversion.

Special rule for assets transferred to ESOPs

The bill provides an exception to the excise tax on reversions in the case of transfers of assets from a defined benefit pension plan upon plan termination to an employee stock ownership plan (ESOP). The amount transferred is not includible in the income of the employer.

In addition, under the bill, the amount transferred may be allocated under the plan to ESOP participants immediately subject to the dollar limits on annual additions under section 415(c). Alternatively, as provided under the plan, the amount transferred may be held in a suspense account pending allocation (provided allocations are made no more slowly than ratably over a 7-year period) or may be used to repay an acquisition loan (as described in section 404(a)(9)). Such allocations, the establishment of a suspense account, or the repayment of a loan is to occur within 90 days after the transfer. Amounts must be used either to acquire employer securities or to repay an acquisition loan and are to be allocated to the accounts of participants (as long as the allocations do not violate sec. 415(a)). If the plan is terminated prior to such amounts being fully allocated to participants' accounts, the employer will be subject to the 10 percent excise tax on such reversion amounts that have not been allocated.

Dividends paid on employer securities held in the suspense account must be either (a) applied to repay an acquisition loan, or (b) paid out currently to plan participants and beneficiaries proportionate to their account balances (attributable to such amounts) on the date such dividends are distributed.

The amounts held in the suspense account are required to be allocated to participants' accounts before any other employer contributions are allocated. In other words, during the period that reversion amounts are held in a suspense account, the employer is not permitted to make additional contributions to the ESOP to the extent that the contributions, when added to the amount held in a suspense account, would exceed the overall limits on annual additions under a defined contribution plan if allocated to participants' accounts.

Amounts transferred to a suspense account that (due to the limitations on contributions and benefits under section 415) cannot be allocated to participants' accounts within seven plan years (including the years in which such amounts were transferred to the plan) must revert to the employer and will be subject to the 10% excise tax in the taxable years in which such reversion occurs.

The waiver of the excise tax is to apply only if at least 50 percent of the employees who are participants in the terminated defined benefit pension plan (as of the date the notice of intent to terminate is filed with the PBGC) are also eligible to participate in the ESOP to which the excess assets are transferred. For this purpose, an employer may disregard those participants in the terminated defined benefit pension plan who are not employed by the employer on the date of the first allocation of such reversion amounts

under the ESOP. All employees participating in the ESOP as of the close of the plan year in which the employer receives a notice of sufficiency of assets from the Pension Benefit Guaranty Corporation with respect to the termination of the defined benefit pension plan are to be entitled to share in that year's allocation of the excess assets in the ESOP.

The bill permits the ESOP to be maintained by any member of a controlled group of corporations, including a corporation other than the corporation that maintained the terminated defined benefit pension plan as long as the 50 percent test is met with respect to the employees participating in the ESOP.

For those employees receiving allocations under the ESOP, the committee intends that the employer provide the employees with a written notice describing the source of the funds attributable to the allocations (i.e., that the amounts represent excess assets determined upon termination of a defined benefit pension plan).

Effective Date

The excise tax applies to a reversion received after December 31, 1985 other than reversions attributable to plan terminations occurring on or before December 31, 1985. For purposes of this provision, a termination is considered to occur on the proposed date of termination.

An exception to the excise tax is provided in the case of a certain employer.

Revenue Effect

The provisions are estimated to decrease fiscal year budget receipts by $10 million in 1987 and $10 million in 1988 and to increase receipts by $30 million in 1989, $30 million in 1990, and $30 million in 1991.

E. Miscellaneous Pension and Deferred Compensation Provisions

1. Discretionary Contribution Plans (sec. 1235 of the bill and sec. 401 of the Code)

Present Law

Under certain types of plans, including profit-sharing plans, the level of employer contributions to the plan may vary from year to year at the discretion of the employer. An employer's discretion over the level of contributions to a profit-sharing plan is limited by the requirement that the employer's contribution to the plan in any given year may not exceed the employer's current or accumulated profits. Also, there is uncertainty under present law whether a tax-exempt or not-for-profit employer may maintain a profit-sharing plan.

Reasons for Change

The committee believes that the present-law requirements that contributions to a profit-sharing plan be made out of current or accumulated profits have no policy justification, and may, in some instances, needlessly deter employers from making contributions to a plan. Further, the committee sees no justification for precluding tax-exempt and not-for-profit employers from maintaining discretionary contribution plans.

Explanation of Provision

Under the bill, an employer's contribution to a profit-sharing plan is not limited to the employer's current or accumulated profits. This provision applies without regard to whether the employer is tax-exempt.

Effective Date

The provision is effective for plan years beginning after December 31, 1986.

Revenue Effect

The provision is estimated to have a negligible effect on budget receipts.

2. Requirement that Collective Bargaining Agreements be Bona Fide (sec. 1236 of the bill and sec. 7701(a)(46) of the Code)

Present Law

Under present law, many of the nondiscrimination standards of the Code applicable to qualified plans apply separately to plans or programs maintained pursuant to an agreement that is found to be

a collective bargaining agreement if there is evidence that retirement benefits were the subject of good faith bargaining between the employer and employee representatives. Similar exclusions are provided with respect to certain welfare benefits provided to employees. Present law provides no clear definition of a collective bargaining agreement.

Reasons for Change

The committee is aware that some promoters of tax avoidance arrangements have entered into arrangements with employers under which, superficially, the employer and its employees are represented by agents in collective bargaining. Under the arrangement, however, no good faith bargaining occurs because the bargaining agent for the employees merely acts in concert with the named bargaining agent for the employer.

In some cases, the named bargaining agent for the employees has obtained a ruling by the Internal Revenue Service that the agent is exempt from income tax because it is a labor organization. Promoters of these arrangements have, on the basis of such a determination, represented to employers that the named agent has been determined to be an employee representative within the meaning of the provisions of the Code and ERISA. Of course, it is clear that a determination with respect to an organization's status for tax exemption is not a determination with respect to whether that organization, even if tax-exempt, is an employee representative.

The committee believes that these arrangements are, in fact, designed for no material purpose other than the improper manipulation of provisions that are appropriate only for legitimate collectively bargained plans. The committee wishes to make clear that it does not regard such an arrangement as the product of good faith bargaining and that it does not consider an entity to be an employee representative merely because of its status for tax exemption or a determination by the Internal Revenue Service with respect to that status. The committee intends that no inference should be drawn from this discussion with respect to the issue of whether such an organization can meet the requirements of the Code for tax-exempt status. The committee also intends that no inference should be drawn from this discussion as to whether the promoters of these arrangements are subject to assessable penalties for the promotion of abusive tax shelters.

Explanation of Provision

Under the bill, it is clarified that no agreement will be treated as a collective bargaining agreement it is a bona fide agreement between bona fide employee representatives and one or more employers.

Effective Date

This provision is effective upon enactment of the bill.

Revenue Effect

The provision is estimated to have a negligible effect on budget receipts.

3. Treatment of Certain Fishermen as Self-Employed Individuals (sec. 1237 of the bill and sec. 401 of the Code)

Present Law

Under present law, certain fishermen who otherwise would be treated as common-law employees under the usual rules for determining an employer-employee relationship are treated as self-employed individuals for purposes of employment taxes (secs. 3121(b)(20) and 3306(c)(20)). To qualify for this treatment under the employment tax provisions, an individual on a boat engaged in catching fish or other forms of aquatic animal life must have an arrangement with the owner or operator of the boat under which (1) the individual does not receive cash remuneration, (2) the individual receives a share of the boat's catch of fish or other forms of aquatic animals or a share of the proceeds from the sale of the catch, and (3) the amount of the individual's share of the catch depends on the amount of the boat's catch of fish or other aquatic animals. This treatment as a self-employed individual does not apply unless the operating crew of the boat (or each boat from which the individual receives a share of the catch) normally is made up of fewer than 10 individuals.

The Internal Revenue Service has held that, although the individuals described above are treated as self-employed individuals for employment tax purposes, they are treated as employees for purposes of determining whether a pension, profit-sharing, or stock bonus plan maintained by the owner or operator of the boat (or boats) is a qualified plan under section 401(a).[9]

Reasons for Change

Under present law, individuals who are members of certain fishing crews are treated as self-employed individuals for some purposes under the tax laws, but not for all such purposes. The committee believes that individuals who are self employed generally should be treated as such for all purposes, rather than just for employment tax purposes.

Further, the committee recognizes that the practical effect of the Internal Revenue Service's position with respect to the status of these fishing crew members under the qualified plan rules is to prevent an individual fishing crew member from establishing a Keogh plan. This means, the committee fears, that these individuals are not receiving adequate pension coverage because the owner or operator of the boat may not maintain a qualified plan for all its employees. Therefore, the committee believes that the rules for eligibility to maintain a Keogh plan should not be inconsistent with the treatment of individuals for employment tax purposes.

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[9] Rev. Rul. 79-101, 1979-1 CB 156.

Explanation of Provision

Under the bill, members of fishing boat crews (described in sec. 3121(b)(20)) are treated as self-employed individuals for purposes of the rules relating to qualified pension, profit-sharing, or stock bonus plans.

Effective Date

The provision is effective for taxable years beginning after December 31, 1986.

Revenue Effect

The provision is estimated to have a negligible effect on budget receipts.

4. Cash-out of certain accrued benefits (sec. 1238 of the bill, and secs. 411(a)(11) and 417 of the Code)

Present Law

Under section 411(a)(11) of the Code, in the case of an employee who separates from service, a pension, profit-sharing, or stock bonus plan may not immediately distribute any portion of the participant's benefit without the participant's consent, if the present value of the participant's accrued benefit exceeds $3,500. The interest rate used in determining whether the present value of a benefit exceeds $3,500 may not exceed the interest rate that would be used (as of the date of the distribution) by the Pension Benefit Guaranty Corporation (PBGC) for purposes of determining the present value of a lump sum distribution upon termination of the plan. The PBGC rate in effect at the beginning of a plan year may be used throughout the plan year if the plan so provides.

With respect to those plans subject to the automatic survivor benefit requirements (secs. 401(a)(11) and 417), if the present value of the benefit under either the qualified joint and survivor annuity or the qualified preretirement survivor annuity exceeds $3,500, then the consent of the participant and spouse (or the surviving spouse if the participant has died) must be obtained before the plan can immediately distribute any part of the present value in a form other than a qualified joint and survivor annuity or a qualified preretirement survivor annuity. The interest rate used may not exceed the interest rate that would be used (as of the date of the distribution) by the PBGC for purposes of determining the present value of a lump sum distribution on plan termination.

For purposes of both the "cash-out" provisions of section 411(a)(11) and the survivor benefit requirements (sec. 417), an accrued benefit is immediately distributable if any part of the benefit may be distributed to the participant before the later of normal retirement age or age 62.

Reasons for Change

The committee is concerned that the present-law cash-out rules encourage plan participants to request a cash out of benefits in order to receive a favorable interest rate assumption on the cash

out. The interest rates required to be provided under present law may lead employers to make plan distributions unavailable until normal retirement age because of an employer's concern about the solvency of the plan assets when all terminating employees request lump sum distributions. Therefore, the committee finds it appropriate to reduce the interest rate required to be provided to participants with respect to cash outs. The committee does not change the interest rate assumptions with respect to involuntary cash outs because the participant is not given a choice of whether or not to take the distribution in that case.

Explanation of Provision

The bill amends the requirement that for purposes of determining the present value of a participant's accrued benefit (sec. 411(a)(11)), a qualified preretirement survivor annuity, or a qualified joint and survivor annuity (sec. 417), the plan use an interest rate no greater than the interest rate that would be used by the PBGC for purposes of determining the present value of a lump sum distribution upon the termination of the plan. Under the bill, a plan would be required to compute the first $3,500 of the present value of a benefit by using an interest rate no greater than the interest rate (deferred or immediate, whichever is appropriate) that would be used by the PBGC (as of the date of distribution) upon the plan's termination. The remaining portion of the present value of the benefit would be required to be determined using an interest rate no greater than 120 percent of the interest rate (deferred or immediate, whichever is appropriate) that would be used by the PBGC (as of the date of distribution) upon the plan's termination. As under present law, for purposes of determining the PBGC interest rate as of the date of distribution, the PBGC rate in effect at the beginning of a plan year could be used throughout the plan year if the plan so provides.

Effective Date

The amendment is applicable for distributions after December 31, 1984. However, the amendment does not apply to distributions that were made after December 31, 1984, and before the date of enactment if such distributions were made in accordance with the requirements of regulations issued under the Retirement Equity Act of 1984.

Revenue Effect

The provision is estimated to have a negligible effect on budget receipts.

5. Time Required for Plan Amendments, Issuance of Regulations, and Development of Section 401(k) Model Plan (secs. 1239-1241 of the bill)

Present Law

If a pension, profit-sharing, or stock bonus plan qualifies under the tax law (sec. 401(a)) then (1) a trust under the plan is generally

exempt from income tax, (2) employers are generally allowed deductions (within limits) for plan contributions for the year for which the contributions are made, even though participants are not taxed on plan benefits until the benefits are distributed, and (3) benefits distributed as a lump sum distribution may be accorded special treatment, or may be rolled over, tax-free, to an individual retirement account, annuity, or bond (IRA) or another qualified plan. To be qualified, a pension, profit-sharing or stock bonus plan, by its terms, must satisfy various specifically enumerated qualification requirements described in section 401(a). Under present law, a plan must comply with these qualification requirements in form as well as operation.

If the qualification provisions are changed, present law generally requires that conforming plan amendments be adopted no later than the last day of the first plan year to which the change applies and the amendment must be effective, for all purposes, not later than the first day of that plan year.[10]

Reasons for Change

Given the number of qualification changes made by this bill, the committee believes it is appropriate to provide an extended remedial amendment period for compliance with these changes.

In order to make section 401(k) plans more widely available to small employers, the committee believes the Secretary of the Treasury should issue determination letters with respect to a model section 401(k) plan.

Explanation of Provision

In general

Under the bill, the provisions generally apply as of the separately stated effective date (generally, years beginning after December 31, 1986, or December 31, 1988). However, a plan will not fail to be a qualified plan on account of changes made in this bill for any year beginning before January 1, 1989, provided—

(1) the plan complies, in operation, with the changes as of the separately stated effective date;

(2) the plan is amended to comply with the changes no later than the last day of the first plan year beginning after December 31, 1988; and

(3) the amendment applies retroactively to the separately stated effective date.

During this period a plan will not be disqualified merely because the plan, solely due to delaying the adoption of conforming amendments, violates the requirement (1) that benefits be definitely determinable, (2) that a plan's terms be set forth in a written document, or (3) that the plan operate in accordance with its terms.

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[10] This "remedial amendment period" may be further extended by the Secretary of the Treasury (sec. 401(b)). Under present law, disqualifying provisions created by statutory changes (other than those made by ERISA and TEFRA) generally are not "disqualifying provisions" eligible for this extended remedial amendment period.

Collectively bargained plans

Under the bill, the separately stated effective dates may be delayed for certain collectively bargained plans. A collectively bargained plan to which the delayed effective dates apply will not fail to be a qualified plan for any year beginning before the later of (1) January 1, 1989, or (2) the earlier of (a) January 1, 1991, or (b) the first plan year beginning after the termination of the collective bargaining agreement (determined without regard to any extension of the terms of the agreement ratified after March 1, 1986) provided three conditions are satisfied.

First, the plan must operate in compliance with the changes for the first plan year beginning after the earlier of (1) December 31, 1988, or (2) the earlier of (a) December 31, 1990, or (b) the termination of the collective bargaining agreement.

Second, plan amendments must be adopted no later than the last day of the first plan year beginning after the later of (1) December 31, 1988, or (2) the earlier of (a) December 31, 1990, or (b) the termination of the collective bargaining agreement.

Third, those amendments must be made effective as of the first day of the first plan year beginning after the later of (1) December 31, 1988, or (2) the earlier of (a) December 31, 1990, or (b) the termination of the collective bargaining agreement.

Issuance of regulations

The bill provides that the Secretary of the Treasury is to issue final regulations with respect to certain provisions of the bill by February 1, 1988, in order to provide time for employers to make plan amendments necessary to comply with the requirements of the bill. The provisions for which these regulations are required to be issued include (1) the rules relating to the integration of benefits under qualified plans, (2) the coverage requirements applicable to qualified plans, (3) the amendments applicable to qualified cash or deferred arrangements (sec. 401(k) plans), and (4) the new nondiscrimination rules for employer matching and employee contributions (sec. 401(m)).

Model plan

Further, in order to make qualified cash or deferred arrangements more feasible for small employers, the bill provides that the Secretary of the Treasury is to publish, no later than May 1, 1987, a model plan document for qualified plans that include qualified cash or deferred arrangements. The bill provides that the Secretary of the Treasury is to solicit input with respect to the design of the model plan and to provide notice and a period for comment with respect to a proposed plan document.

Effective Date

This provision applies upon enactment of the bill.

Revenue Effect

This provision has no effect on fiscal year budget receipts.

F. Employee Benefit Provisions

1. Nondiscrimination Rules for Certain Statutory Employee Benefit Plans (sec. 1251 of the bill, secs. 79, 105, 106, 117, 120, 125, 127, 129, 132, 505 and new sec. 89 of the Code)

Present Law

Overview

Under present law, certain employer-provided employee benefits are excluded from the gross income of employees if provided under certain statutorily prescribed conditions. Similar exclusions generally apply for employment tax purposes.

Among those conditions that generally apply to the exclusion of employer-provided employee benefits is the requirement that employee benefits be provided on a nondiscriminatory basis. Thus, with the exception of the exclusion for employer-provided health insurance, each employee benefit exclusion is not available unless nondiscrimination rules are met that require that the benefit not be provided on a basis that favors certain categories of employees who are officers, owners, or highly compensated. Failure to satisfy the applicable nondiscrimination test for a specific benefit results in a denial of the tax exclusion for all employees receiving the benefit or only for the employees in whose favor discrimination is prohibited, depending on the benefit.

Separate nondiscrimination rules apply with respect to each benefit. Thus, an individual in whose favor discrimination is prohibited for one benefit may or may not be such an individual for another benefit. Also, what constitutes impermissible discrimination and the consequences of such discrimination differ with respect to different benefits.

Health benefit plans

Under present law, a nondiscrimination test is not applied as a condition of the exclusion of health benefits provided by an employer under an insured plan, and the exclusion of medical benefits and reimbursements provided under such insurance (secs. 105 and 106). However, if an employer provides its employees with health benefits under a self-insured medical reimbursement plan (sec. 105(h)), the exclusion of a medical reimbursement under such plan is available to a highly compensated individual only to the extent that the plan does not discriminate in favor of highly compensated employees.

A self-insured health plan is discriminatory if it favors highly compensated individuals either as to eligibility to participate or as to benefits. For purposes of this nondiscrimination rule, certain related employers are treated as a single employer.

Under the eligibility test, a self-insured health plan must benefit (1) at least 70 percent of all employees, (2) at least 80 percent of all eligible employees, but only if at least 70 percent of all employees are eligible to participate, or (3) a classification of employees that does not discriminate in favor of highly compensated individuals. In determining whether a plan satisfies any of these tests, employees who have not completed 3 years of service, employees who have not attained age 25, part-time and seasonal employees, employees covered by a collective bargaining agreement, and nonresident aliens with no U.S. earned income may be disregarded.

The benefits provided under a self-insured health plan will be treated as discriminatory unless all benefits provided for participants who are highly compensated individuals are provided for all other participants.

For purposes of these rules, highly compensated individuals are (1) the 5 highest paid officers, (2) shareholders owning more than 10 percent of the stock of the employer, and (3) employees who are among the highest paid 25 percent of employees (excluding employees who are not participants and who may be disregarded for purposes of the eligibility test).

Group-term life insurance plans

Under present law, an exclusion is provided for the cost of group-term life insurance coverage (up to $50,000) under a plan maintained by an employer (sec. 79). If a group-term life insurance plan is determined to be discriminatory, the exclusion of the cost of $50,000 of group-term life insurance does not apply with respect to key employees. A discriminatory plan is one that discriminates in favor of key employees as to eligibility to participate or as to the type or amount of benefits available under the plan. For purposes of these rules, related employers are treated as a single employer.

With respect to eligibility, a group-term life insurance plan must satisfy one of the following tests: (1) the plan benefits at least 70 percent of all employees; (2) at least 85 percent of all participants are not key employees; (3) the class of employees receiving benefits does not discriminate in favor of key employees; or (4) in the case of a plan that is part of a cafeteria plan, the cafeteria plan requirements are met. In determining whether a plan satisfies this eligibility test, employees who have not completed 3 years of service, part-time and seasonal employees, employees covered by a collective bargaining agreement, and nonresident aliens who receive no U.S. earned income may be disregarded.

For purposes of determining whether the type or amount of benefits under the plan discriminates in favor of key employees, all benefits available to key employees must be available to all other employees. Group-term life insurance benefits will not be considered discriminatory merely because the amount of life insurance provided to employees bears a uniform relationship to compensation.

The term "key employee" is generally defined as it is under the top-heavy rules applicable to qualified pension plans: officers, the top 10 employee-owners, 5-percent owners, and one-percent owners receiving at least $150,000 in annual compensation (sec. 416(i)). Employees are key employees with respect to a year if they fall within

one of the above categories at any time during the current year or any of the 4 preceding years.

Group legal services plans

The exclusion for contributions to or services provided under an employer-maintained group legal services plan is available to employees only if (1) the plan benefits a class of employees that does not discriminate in favor of employees who are officers, shareholders, self-employed individuals, or highly compensated, and (2) the contributions or benefits provided under the plan do not discriminate in favor of such employees (sec. 120). In determining whether a plan benefits a nondiscriminatory classification of employees, employees covered by a collective bargaining agreement may be disregarded. In addition, the exclusion is available only if no more than 25 percent of the amounts contributed during a year may be provided for 5-percent owners (or their spouses or dependents).

Educational assistance programs

Under present law, the amounts paid or expenses incurred (up to $5,000 a year) for an employee under an employer-provided educational assistance program are excluded from income (sec. 127). The exclusion is not available if the program benefits a class of employees that is discriminatory in favor of employees who are officers, owners, or highly compensated (or their dependents). Under this test, employees covered by a collective bargaining agreement may be disregarded. Also, the exclusion is available only if no more than 5 percent of the amounts paid or incurred by the employer for educational assistance may be provided for 5-percent owners (or their spouses or dependents).

Dependent care assistance programs

Present law provides an exclusion from income for amounts paid or incurred for an employee under a dependent care assistance program (sec. 129). The exclusion is not available unless (1) the program benefits a class of employees that does not discriminate in favor of employees who are officers, owners, or highly compensated (or their dependents), and (2) the contributions or benefits provided under the plan do not discriminate in favor of such employees. In determining whether a program benefits a nondiscriminatory classification of employees, employees covered by a collective bargaining agreement may be disregarded. In addition, under the applicable concentration test, the exclusion is not available if more than 25 percent of the amounts paid or incurred by the employers for dependent care assistance are provided for 5-percent owners (or their spouses or dependents).

Welfare benefit plans

A voluntary employees' beneficiary association or a group legal services fund that is part of an employer plan is not exempt from taxation unless the plan of which the association or fund is a part meets certain nondiscrimination rules (sec. 505). Under these rules, no class of benefits may be provided to a classification of employees that is discriminatory in favor of highly compensated employees. In addition, with respect to each class of benefits, the benefits may

not discriminate in favor of highly compensated employees. A life insurance, disability, severance pay, or supplemental unemployment compensation benefit will not fail the benefits test merely because the amount of benefits provided to employees bears a uniform relationship to compensation. For purposes of these rules, certain related employers are treated as a single employer.

For purposes of the above rules, the following employees may be disregarded: (1) employees with less than three years of service; (2) employees who have not attained age 21; (3) seasonal or less than half-time employees; (4) employees covered by a collective bargaining agreement; and (5) nonresident aliens with no U.S. earned income. Under a special rule, if a benefit, such as group legal services, is covered by a separate nondiscrimination rule, that separate rule will apply in lieu of the rules described above.

The term "highly compensated individual" includes any individual who is one of the five highest paid officers, a 10 percent shareholder, or among the highest paid 10 percent of all employees. For purposes of determining the highest paid 10 percent of all employees, employees who have not completed three years of service, employees who have not attained age 25, part-time and seasonal employees, employees covered by a collective bargaining agreement, and nonresident aliens with no U.S. earned income may be disregarded.

These nondiscrimination rules also apply for certain other purposes. For example, they must be satisfied in order for an employer to be able to deduct contributions to a welfare benefit fund to provide post-retirement life insurance or health benefits. Also, post-retirement life insurance or a post-retirement health benefit provided through a welfare benefit fund will be subject to a 100 percent excise tax if the plan of which the fund is a part does not satisfy these nondiscrimination rules.

Cafeteria plans

Under a cafeteria plan, a participant is offered a choice between cash and one or more employee benefits. The mere availability of cash or certain taxable benefits under a cafeteria plan does not cause an employee to be treated as having received the available cash or taxable benefits for income tax purposes if certain conditions are met (sec. 125). This cafeteria plan exception to the constructive receipt rules does not apply to any benefit provided under the plan if the plan discriminates in favor of highly compensated individuals as to eligibility to participate or as to contributions and benefits. For purposes of these rules, certain related employers are treated as a single employer.

A cafeteria plan does not discriminate as to eligibility to participate if (1) the plan benefits a class of employees that does not discriminate in favor of employees who are officers, shareholders, or highly compensated, and (2) employees who have completed 3 years of service (or such shorter period as specified in the plan) are eligible to participate.

A cafeteria plan will not be considered to discriminate as to contributions and benefits if statutory nontaxable benefits and total benefits (or employer contributions allocable to statutory nontaxable benefits and employer contributions for total benefits) do not

discriminate in favor of highly compensated participants. If a cafeteria plan provides health benefits, the plan will not be treated as discriminatory if the following tests are met: (1) contributions on behalf of each participant include either (a) 100 percent of the cost of health benefit coverage of the majority of highly compensated participants who are similarly situated, or (b) 75 percent of the cost of health benefit coverage of the similarly situated participant with the highest cost health benefit coverage under the plan; and (2) contributions or benefits with respect to other benefits under the plan bear a uniform relationship to compensation. If a cafeteria plan is maintained pursuant to a collective bargaining agreement between employee representatives and 1 or more employers, the plan is deemed to be nondiscriminatory.

A participant or individual is considered highly compensated for purposes of the cafeteria plan rules if that individual is an officer, a 5-percent shareholder, highly compensated, or a spouse or dependent of any of the above.

In addition, under a cafeteria plan, no more than 25 percent of the aggregate of the statutory nontaxable benefits provided to all employees under the plan may be provided to key employees. Certain related employers are treated as a single employer for purposes of this rule. The term "key employee" has the meaning given to such term for purposes of the top-heavy rules applicable to qualified retirement plans (i.e., officers, the top 10 employee-owners, 5-percent owners, and one-percent owners with at least $150,000 in compensation).

Reasons for Change

Under present law, the tax-favored treatment of employer-provided employee benefits reduces the Federal income tax base and reduces Federal budget receipts. However, the committee believes these costs are justified because employer-provided employee benefits fulfill important social policy objectives, such as increasing health insurance coverage among taxpayers who otherwise would not purchase or could not afford such coverage. For example, employer-provided health insurance and life insurance coverage is currently provided to more than 80 percent of workers in the United States.

The committee believes that strict nondiscrimination rules are a necessary adjunct to this public policy rationale because they permit the exclusion of employee benefits only if the benefits are provided to a broad cross-section of employees.

The committee further believes that employer-provided health insurance should be subject to nondiscrimination rules. As with other employee benefits, the exclusion of such insurance from employees' income should be conditioned on its nondiscriminatory provision to a broad cross-section of employees.

The definition of prohibited group members under present law is generally vague, leaving unclear, for example, who qualifies as an "officer," "owner," or "highly compensated employee." Similarly, little specific guidance is provided as to whether a particular pattern of coverage discriminates in favor of prohibited group members.

Therefore, the committee believes that the present-law nondiscrimination rules should be modified to expand coverage particularly with respect to health and group-term life insurance plans and to provide more consistent principles for employee benefit exclusions. As a general rule, the committee believes that, to the extent possible, the nondiscrimination rules should require employers to cover substantial numbers of employees on a broad basis, rather than selective classes of employees.

The committee recognizes that employers desire flexibility in designing employee benefit programs. However, the committee believes that flexibility should be provided only to the extent not inconsistent with the nondiscrimination rules. For example, if an employer operates, for legitimate economic reasons, multiple lines of business, the employee benefit structures in each line of business may differ because of historical trends within each industry. The committee bill permits employers to test the new nondiscrimination rules separately with respect to each line of business. The committee is concerned, however, that the line of business exception not be administered in a manner that circumvents the committee's basic premise that highly compensated employees should not be permitted to exclude employee benefits unless the employer's plan benefits substantial numbers of the employer's employees.

Explanation of Provisions

Overview

The bill establishes comprehensive nondiscrimination rules for certain statutory employee benefit plans. Under the bill, a highly compensated employee who is a participant in any discriminatory statutory employee benefit plan is taxed on the value of such employee's employer-provided benefit under the plan.

The bill (1) revises the nondiscrimination rules applicable to group-term life insurance plans and self-insured accident or health plans; (2) extends those rules to insured accident or health plans; (3) establishes a new nondiscrimination test applicable (at the election of the employer) to any type of statutory employee benefit plan, in lieu of certain applicable present law nondiscrimination rules; (4) establishes a concentration test applicable to both group-term life plans and accident or health plans, and an additional concentration test applicable only to group-term life plans; (5) establishes a uniform definition of highly compensated employee; (6) modifies the list of employees who may be excluded from consideration in applying the coverage rules; and (7) permits satisfaction of the coverage rules on a controlled group or line of business basis.

General rule for inclusion

In general

Under the bill, a highly compensated employee who is a participant in a discriminatory statutory employee benefit plan or a discriminatory cafeteria plan (or a plan that would be a cafeteria if employees could choose cash or a taxable benefit) is required to include in income an amount equal to the employee's employer-provided benefit under the plan.

The bill also provides that the gross income of any employee, whether or not highly compensated, includes the employee's employer-provided benefit under a statutory employee benefit plan, unless (a) the plan is in writing; (b) the employees' rights under the plan are legally enforceable; and (c) the employer established the plan with the intention of maintaining it indefinitely.

Statutory employee benefit plan

Under the bill, a "statutory employee benefit plan" includes employer-maintained (a) group-term life insurance plans; (b) accident or health benefit plans (whether self-insured or insured); (c) qualified tuition reduction programs; (d) group legal services plans (whether self-insured or insured); (e) educational assistance programs; (f) dependent care assistance programs; and (g) a fringe benefit program providing no-additional-cost services, qualified employee discounts, or employer-operated eating facilities within the meaning of section 132. With respect to disability coverage, the bill provides that coverage attributable to employer contributions (including elective contributions) for disability benefits that are excludable from income under section 105(b) or (c) of the Code is subject to the nondiscrimination rules applicable generally to statutory employee benefit plans. Other employer-provided disability coverage is not subject to the nondiscrimination requirements.

Employer-provided benefit

In general.—In the case of an insurance-type plan that satisfies the writing, enforceability, and indefinite duration requirements described above, the bill defines an employee's employer-provided benefit as the value of the coverage provided during the taxable year to or on behalf of such employee, to the extent attributable to contributions made by the employer. In the case of any other plan, an employee's employer-provided benefit is defined under the bill as the value of the benefits provided to or on behalf of such employee, to the extent attributable to contributions made by the employer.

In the case of a cafeteria plan (or a plan that would be a cafeteria plan if employees could choose cash or a taxable benefit), an employee's elective contributions are treated as employer contributions for purposes of determining the value of the employee's employer-provided benefit.

Discriminatory benefits.—For purposes of determining the amount includible in income of a highly compensated employee for discriminatory benefits, the employer-provided benefit of any highly compensated employee in a discriminatory plan is equal to the employer-provided benefits to such employee under all statutory employee benefit plans of the employer of the same type. Statutory employee benefit plans are of the same type if the benefits provided under the plans are eligible for exclusion from income under the same section of the Code. In the case of a cafeteria plan (or a plan that would be a cafeteria plan if employees could choose cash or a taxable benefit), all benefits provided under the plan are to be treated as plans of the same type.

Valuation regulations.—The committee intends that the Secretary of the Treasury will prescribe regulations that provide guid-

ance in determining the value of insurance coverage and of noninsurance benefits. The Secretary may establish administrable, mechanical methods of valuing the coverage or benefits. For example, in determining the value of health care coverage, the Secretary may provide, in appropriate circumstances, that the value of coverage provided under a plan to any employee may be determined by reference to the average employer cost per employee covered under the plan. The Secretary may also consider establishing a table identifying and valuing health plan features, so that the value of coverage under a plan could be determined by reference to the table.

The Secretary may, in prescribing such regulations, provide adjustments to take account of factors relevant to the determination of the value of a benefit. In addition, with respect to the percentage test and the reasonable classification test and for purposes of determining whether plans provide comparable benefits, the Secretary is directed to specify an index that takes into account differences in costs for plans maintained in geographically dispersed areas.

Nondiscrimination rules

In general

Accident or health plans and group-term life insurance.—Under the bill, an accident or health plan (whether or not insured) or a group-term life insurance plan is considered discriminatory unless the plan satisfies (a) a percentage test; (b) a reasonable classification test; (c) an average benefits test; or (d) an average income exclusion test. These tests (other than the average income exclusion test) do not apply to plans other than accident or health plans and group-term life insurance plans.

Other plans.—A plan other than an accident or health plan or a group-term life insurance plan is generally considered discriminatory unless the plan meets (a) the applicable present law nondiscrimination rules; or (b) the new average income exclusion test. In addition, a plan is required to satisfy any concentration test applicable to the plan under present law.

Percentage test

A plan satisfies the percentage test if it benefits 80 percent or more of all employees of the employer.

Reasonable classification test

A plan meets the reasonable classification test if it benefits a reasonable classification of employees that the Secretary of the Treasury finds does not allow more than a reasonable difference (in favor of highly compensated employees) between the coverage percentage of highly compensated employees and the coverage percentage of other employees.

The committee intends that the Secretary of the Treasury interpret the reasonable classification test to permit no more than a reasonable disparity between the ratio of the highly compensated employees benefited by a plan to all such employees and the ratio of nonhighly compensated employees benefited by the plan to all nonhighly compensated employees. The committee also intends

that the basic principles of the test be interpreted in a manner consistent with their interpretation in the pension area.

Average benefit test

In general.—An accident or health plan or group-term life insurance plan that does not meet the reasonable classification test will be treated as meeting that test if (1) the plan meets the requirements of section 410(b)(1)(B) as in effect immediately before the date of enactment of the Tax Reform Act of 1986; (2) the average benefit provided to employees not covered by an alternative plan is at least 60 percent of the average benefit provided to employees covered by an alternative plan (or plans); and (3) in the case of an accident or health plan, at least 80 percent of the employer's non-highly compensated employees are eligible to participate in one or more plans of the same type and the benefits available to each such employee are equal to at least 40 percent of the average benefits provided to employees covered by an alternative plan.

Plans of the same type.—The test is applied separately to health and group-term life plans. If an employer elects to apply the test to a health plan, the test is applied on an aggregate basis to all health plans maintained by the employer. Similarly, if the employer elects to apply the test to a group term life insurance plan, the test is applied on an aggregate basis to all such plans maintained by the employer.

Alternative plan.—The term "alternative plan" is defined under the bill as any plan that meets the requirements of section 410(b)(1)(B) as in effect immediately before the date of enactment of the Tax Reform Act of 1986, but does not meet the requirements of the reasonable classification test without regard to the average benefit test.

Average benefit.—The bill provides that the average benefit provided to employees under a plan is to be determined in such manner as prescribed by the Secretary. The benefit includes all amounts excludable under a plan, including elective contributions.

For purposes of applying the average benefit test in a particular year, the average benefit is to be computed, at the election of the employer, on the basis of (a) that plan year or (b) a consecutive plan year period (not in excess of 5) ending with the current plan year. The consecutive plan year period chosen by the employer must be uniformly applied, and may not be changed without the consent of the Secretary of the Treasury.

Employees in more than one plan.—In the case of an employee who receives benefits under an alternative plan, as well as under a plan that is not an alternative plan, for purposes of calculating the average benefit percentage of the alternative plan (or plans), only the benefits provided to the employee under the alternative plan are taken into account. For purposes of calculating the average benefit percentage of the non-alternative plans, only the benefits received from the non-alternative plans are taken into account.

As an exception to this rule, the bill provides that in the case of a highly compensated employee covered by both an alternative plan and a plan other than an alternative plan, the benefits received by the employee from plans other than an alternative plan are treated as received by the employee under the alternative plan.

A highly compensated employee who is not covered by any plan is treated as covered by an alternative plan for purposes of computing the average benefit percentage of the alternative plan.

Average income exclusion test

Applicability.—An accident or health plan, or a group-term life insurance plan that does not satisfy the reasonable classification test will be treated as satisfying the test if the plan satisfies the average income exclusion test. In addition, in the case of a statutory employee benefit plan other than an accident or health plan or a group-term life insurance plan, and in the case of a cafeteria plan, a plan that satisfies the average income exclusion requirements test will be deemed to satisfy the present law nondiscrimination rules (other than concentration tests) applicable to such plan. In addition, if the requirements of the average income exclusion test are met with respect to a cafeteria plan, then the requirements of the test are treated as satisfied with respect to each benefit provided under the plan.

General requirements.—A plan meets the requirements of the average income exclusion test if (1) the employer elects the application of the test with respect to all plans of the same type maintained by the employer or, in the case of a cafeteria plan, elects the application with respect to all benefits under the cafeteria plan, and (2) the average exclusion ratio for employees of that employer under all such plans of the same type is at least 4/5.

Plans of the same type.—For purposes of the test, two or more plans are treated as plans of the same type if the benefits provided under the plan are eligible for exclusion from income under the same section of the Code. However, in the case of a cafeteria plan, all benefits provided under the plan are to be aggregated and treated as benefits of the same type, except that the employer may elect to test separately the health coverage provided for spouses or dependents of employees. See special rules for accident or health plans, below. A plan that would be a cafeteria plan, but for the fact that the plan offers no cash or taxable option, is treated as a cafeteria plan for purposes of the average income exclusion test.

Average exclusion ratio.—The average exclusion ratio refers to the ratio of (1) the average exclusion amount for nonhighly compensated employees, to (2) the average exclusion amount for highly compensated employees.

Average exclusion amount.—The term "average exclusion amount" with respect to highly compensated employees is defined under the bill as an amount equal to the aggregate amount provided under the plans being tested that is excludable from income by highly compensated employees divided by the total number of highly compensated employees employed by the employer. The average exclusion amount with respect to nonhighly compensated employees is determined in the same manner as the average exclusion amount for highly compensated employees. The exclusion amount, of course, includes elective contributions.

Special rules for accident or health plans.—Under the bill, for purposes of applying the average income exclusion test to accident or health plans (except in the case of a cafeteria plan that offers a health plan option, as well as other types of benefits), an employer

may elect to disregard any employee if the employee and the employee's spouse and dependents (if any) are covered by an accident or health plan maintained by another employer.

In addition, if an employer maintains an accident or health plan that provides family coverage to those employees with spouses or dependents, the employer may elect to test separately the coverage for employees and the coverage for spouses or dependents as if the two types of coverage constituted two different types of plans. For purposes of testing the coverage for spouses or dependents, the bill permits an employer to take into account only employees with spouses or dependents who are not covered by an accident or health plan maintained by the employers of the spouses and dependents.

An employer who elects either of these options must obtain and maintain, in such manner as the Secretary of the Treasury prescribes, adequate sworn statements to demonstrate whether individuals have spouses, dependents, or other accident or health coverage. The committee intends that an employer may not treat a nonhighly compensated employee as having coverage from another employer, as not having a family, or both, unless the employer has a sworn statement to that effect which includes, with respect to coverage, the name of the insurer and the policy number. In the case of a highly compensated employee, the committee intends that the opposite presumptions are to apply. Thus a highly compensated employee may not be treated as not having coverage from another source, as not having a family, or both, unless the employer has a sworn statement to that effect.

Special rule for group-term life insurance.—For purposes of determining whether the average income exclusion test is satisfied for a group-term life insurance plan, or a cafeteria plan offering such a benefit, the amount attributable to the group-term life insurance benefit that is excludable from income under the plan is to be determined in the same manner as such amount is determined under section 79, for an individual who is age 30. In addition, group-term life insurance coverage in excess of $50,000 may be disregarded. The committee intends that these special rules do not apply for income inclusion purposes if, for example, the plan being tested is determined to be discriminatory.

Highly compensated employees

In general.—For purposes of the nondiscrimination rules for all employee benefit plans, the bill provides a new uniform definition of highly compensated employees. (For a detailed description of this definition, see the discussion in Part A, number 2, above.) Under the bill, an employee is treated as highly compensated with respect to a year if, at any time during the year or the preceding year, the employee (1) was a 5-percent owner of the employer (as defined in sec. 416(i)); (2) earned more than $100,000 in annual compensation from the employer; (3) earned more than $50,000 in annual compensation from the employer and was a member of the top-paid group of the employer during the same year; or (4) was an officer of the employer (as defined in sec. 416(i)). The $50,000 and $100,000 thresholds are indexed by reference to the method, as of May 1, 1986, for adjusting for percentage increases in the Social Security

wage base (i.e., at the same time and in the same manner as the adjustments to the dollar limits on benefits under defined benefit pension plans).

This definition is the same as the definition of highly compensated employees for purposes of the qualified plan requirements.[1]

Excludable employees

In general.—The bill generally provides that certain classes of employees may be disregarded in applying the coverage rules if neither the plan, nor any other plan of the same type, benefits any employee in such class. The classes of excludable employees are (1) in the case of an accident or health plan (other than a plan providing only noncore benefits) employees who have not completed at least 180 days of service (or such shorter period of service as may be specified in the plan); (2) in the case of any other statutory employee benefit plan (including an accident or health plan providing only noncore benefits), employees who have not completed one year of service (or such shorter period of service as may be specified in the plan); (3) employees who normally work less than half time (or such lesser amount as may be specified in the plan); (4) employees who normally work fewer than six months during any year (or such lesser amount as may be specified in the plan); and (5) employees who have not attained age 21 (or such lower age as may be specified in the plan). In addition, employees included in a unit of employees covered by a collective bargaining agreement may be disregarded if the plan does not benefit any employee in that unit. Finally, nonresident aliens who receive no United States earned income may be disregarded, regardless of whether any such individuals are covered by a plan.

Conditions for exclusions.—Under the bill, in applying the nondiscrimination rules, an employer may exclude from consideration a category of excludable employees only if no excludable employee in that category benefits under the plan being tested or any other employee benefit plan of the employer that provides the same type of statutory employee benefit. Statutory employee benefits are treated as being of the same type if they are eligible to be excluded from income under the same section of the Code. Thus, if an employer maintains two group-term life insurance plans, only one of which excludes employees with less than a year of service, the employer is not permitted to exclude from consideration employees with less than a year of service in testing either plan for compliance with the nondiscrimination rules.

In the case of a cafeteria plan (including a plan that would be a cafeteria plan if employees could elect cash or a taxable benefit) for purposes of applying the nondiscrimination rules, an employer may exclude a category of excludable employees from consideration only if those employees are excluded from benefiting under any option offered by the cafeteria.

The bill contains certain exceptions, generally described below, to the rule that if even one excludable employee is covered by a plan, all employees who are excludable on the same basis (and on

[1] *See* the description in Part A, number 2 above.

no other basis) as the covered employee must be taken into account in applying the nondiscrimination rules to the plan (and any other statutory employee benefit plan offering the same type of benefits).

Core and noncore benefits.—If a plan offering only noncore health benefits excludes employees with less than a year of service, the employer sponsoring the plan is not required to take into consideration employees with less than a year of service merely because another plan maintained by the employer offering core health benefits has a shorter service requirement. Noncore health benefits consist of coverage for dental, vision, psychological and orthodontia expenses and elective cosmetic surgery.

Line of business.—If an employer elects to apply the nondiscrimination rules on a separate line of business or separate operating unit basis, the employees who may be excluded from consideration are determined on a separate line of business or separate operating unit basis. Thus, for example, if (a) an employer maintains a statutory employee benefit plan for a line of business, (b) the nondiscrimination rules are applied to the plan on a line of business basis, and (c) all plans providing benefits of the same type to employees in that line of business exclude all employees who have not attained the age of 21, then the employer may exclude from consideration in applying the nondiscrimination rules to the plan, all employees in that line of business who have not attained age 21, even if the employer maintains a plan that does not impose an age requirement for employees in another line of business.

Collective bargaining agreement.—If no employee in a unit of employees covered by a collective bargaining agreement is covered by a plan, employees in that unit may be disregarded in testing a plan for discrimination, even if the employer maintains a second plan that provides similar benefits and that covers employees in such collective bargaining unit. However, for purposes of applying the average benefits test and the average income exclusion test, if any employees in a unit of employees covered by a collective bargaining agreement are covered by any of the plans to which the tests are applied, then all employees in that unit are required to be taken into account.

Nonresident aliens.—Nonresident aliens with no United States source income may be disregarded regardless of whether any such individuals are covered by the plan being tested for nondiscrimination or by any other plan maintained by the employer providing the same type of benefits.

Separate testing.—The bill also provides that if, for purposes of applying the nondiscrimination rules to a plan ("first plan"), certain employees ("the excludable employees") could be excluded from consideration but for the fact that certain of such employees are covered by another plan ("second plan") that provides the same type of employee benefits, the excludable employees may be disregarded for purposes of testing the first plan if the second plan satisfies the nondiscrimination rules with respect to the excludable employees (treating the excludable employees as the only employees of the employer).

For example, assume an employer's business consists of two divisions, "A" and "B" that do not constitute separate lines of business

or operating units. The employer maintains a group-term life insurance plan for the employees of both divisions who have at least one year of service ("Plan 1"). The employer also maintains a group-term life insurance plan for employees in Division A with less than a year of service ("Plan 2"). In testing whether Plan 1 meets the coverage rules applicable to group-term life insurance plans, the employer normally would be required to take into consideration all employees with less than a year of service, because Plan 2 covers some of those employees. However, if Plan 2 satisfies the nondiscrimination rules with respect to those employees with less than one year of service (treating those employees as the only employees of the employer), then the employees with less than one year of service are not required to be taken into consideration in testing Plan 1 for compliance with the nondiscrimination rules.

Supplemental employees.—The committee also intends that Treasury regulations will provide a limited exception to the rule that employees who otherwise are excludable as employees who do not normally work six months a year or 180 days may not be disregarded if any plan of the employer does not exclude such employees. The limited exception will be available if (1) substantially all employees of the employer (other than supplemental employees) generally are eligible to participate in an accident or health plan (or other employee benefit plan) within 30 days after the date of hire, (2) the employer also employs supplemental employees who generally do not work more than 1,000 hours or more than 180 days, (3) the supplemental employees generally are not rehired if they have previously been supplemental employees, and (4) the supplemental employees do not exceed 15 percent of the employer's workforce.

Under this limited exception, supplemental employees who are (1) retired employees of the employer who are covered under an accident or health plan of the employer maintained for retirees or (2) students hired by the employer under a work-study program, may be disregarded in determining whether the employer's employee benefit plans satisfy the nondiscrimination requirements. Of course, this limited exception would not be available if any supplemental employees are eligible to participate in any employee benefit plan of the employer (other than a plan maintained for retired employees).

Separate lines of business or operating units

In general.—A statutory employee benefit plan is generally required to satisfy the relevant nondiscrimination rules on an aggregate basis. If, however, an employer establishes to the satisfaction of the Secretary of the Treasury that the employer operates separate lines of business or operating units for bona fide business reasons, certain of the coverage rules contained in the bill (i.e., the reasonable classification test, the average benefits test, and the average income exclusion test) may be applied separately with respect to employees in each line of business or operating unit. However, a plan will not be treated as satisfying the nondiscriminatory coverage rules on a line of business or operating unit basis unless the plan also satisfies the classification test of section 410(b)(1)(B)

as in effect immediately before enactment of the Tax Reform Act of 1986 ("classification test").

Thus, in the case of an accident or health plan or a group-term life insurance plan that satisfies the present-law classification test, and that is maintained by the employer for employees in a line of business or operating unit, the plan will not be considered discriminatory if, with respect to the employees in the line of business or operating unit for which the plan is maintained, the plan satisfies (a) the reasonable classification test; (b) the average benefits test; or (c) the average income exclusion test. Similarly, a plan other than an accident or health plan or a group-term life insurance plan that satisfies the present-law classification test and that is maintained for employees in a separate line of business or operating unit that satisfies the above requirements is permitted to satisfy the average income exclusion test on a line of business or operating unit basis.

Safe harbor for lines of business or operating units.—The bill provides a safe harbor rule under which a separate line of business or operating unit is treated as being operated for bona fide business reasons if such line of business or operating unit is a separate self-sustaining unit and if (1) each line of business or operating unit has at least 50 employees who do not perform services for any other line of business or operating unit; and (2) the "highly compensated employee percentage" of the line of business or operating unit is (a) not less than one-half, and (b) not more than twice, the percentage of all employees of the employer who are highly compensated. For purposes of this requirement, the highly compensated employee percentage of a line of business or operating unit will be treated as not less than one-half of the percentage of all employees of the employer who are highly compensated employees if at least 10 percent of all highly compensated employees of the employer are employed by the line of business or operating unit.

Highly compensated employee percentage.—Under the bill, the term "highly compensated employee percentage" means the percentage of all employees performing services for a line of business or operating unit who are highly compensated employees. For purposes of determining the number of employees performing services for a line of business or operating unit, and the highly compensated employee percentage of a line of business or operating unit, the committee intends that the Secretary develop rules governing the circumstances under which an employee will be treated as performing services for a line of business or operating unit.

Impermissible use of line of business distinction.—The committee intends that the Secretary prescribe by regulation what constitutes a line of business or operating unit. It is the intent of the committee that the line of business or operating unit concept not be used to undermine the nondiscrimination rules. Thus, for example, certain job classifications (such as hourly employees or leased employees) are not considered to be separate lines of business or operating units. Also, for example, the committee does not intend that secretaries and other support service personnel be treated as in a line of business or operating unit separate from the lawyers or other professionals for whom such personnel perform services, or that nurses and laboratory personnel be treated as in a line of business

or operating unit separate from the medical doctors for whom they perform services. In addition, the members of an affiliated service group (sec. 414(m)) may not be treated as separate lines of business or operating units.

In general, the committee intends that a headquarters or home office is not to be considered a separate line of business or operating unit. Instead, the Secretary is to prescribe regulations under which headquarters personnel may be considered employed by one line of business or operating unit even though such personnel perform services for other lines of business or operating units.

It is generally intended that a line of business or operating unit include all employees necessary for preparation of certain classes of property for sale or the provision of services to customers. Certain exceptions to this rule may be established by regulation where one employer has two operations that are vertically integrated and that are traditionally operated by unrelated entities.

Combining lines of business.—The committee intends that if a line of business or operating unit would be recognized, but for the fact that it does not satisfy the 50 employee or the highly compensated employee percentage test, it may be combined with another line of business or operating unit, provided that the aggregate entity satisfies the 50 employee or the highly compensated employee percentage test. With respect to any plan maintained for employees of one of the combined lines of business, the plan is required to satisfy the coverage rules with respect to the aggregate entity.

Excludable employees.—For purposes of determining the number of employees in a line of business or operating unit and the highly compensated employee percentage of a line of business or operating unit, an employer may disregard the categories of employees that may be disregarded for purposes of determining which employees are highly compensated employees. (See the description in Part A, number 2, above.).

Common plan for more than one line of business.—The bill provides that if employees of more than one line of business or operating unit are eligible to participate in a plan, then all such lines of business or operating units are to be treated as one line of business or operating unit.

Definitions

Insurance-type plans

Insurance-type plans are defined as employer-maintained plans that provide accident or health benefits, group-term life insurance benefits, and group legal benefits.

Other plans

The bill treats all other statutory employee benefit plans as not being insurance-type plans, regardless of whether the benefits under such plans are funded by insurance.

Employer and employees

Aggregation.—Under certain circumstances, related employers are treated as a single employer for purposes of the nondiscrimina-

tion requirements (sec. 414(b), (c), and (m)). In addition, leased employees are treated for purposes of the nondiscrimination rules as employees of the person or organization for whom they perform services (sec. 414(n)). The bill provides that the Secretary's general regulatory authority to prevent abuse of employee benefit requirements shall apply (sec. 414(o)).

Self-employed individuals.—For purposes of the nondiscrimination rules governing qualified group legal services plans, educational assistance programs and dependent care assistance programs, self-employed individuals are treated as employees. An individual who owns the entire interest in an unincorporated trade or business is treated as his own employer and a partnership is treated as the employer of each partner.

Separate plans

For purposes of applying (a) the reasonable classification test; (b) the percentage test; and (c) the present-law classification test embodied in the average benefit test and in the line of business or operating unit rule, each option or different benefit offered under an accident or health plan or a group-term life insurance plan is treated as a separate plan. This means, for example, that if two types of insurance coverage vary in any way (including the amount of the employee contribution), they will be considered separate plans. Thus, in the case of health plans under which there are different levels or types of health benefit coverage, each separate level or type of health coverage must be tested as a separate plan.

The bill provides that in the case of group-term life insurance, the provision of insurance coverage that varies in proportion to compensation is not to be considered as the provision of different options or benefits with respect to such varying coverage.

The committee intends that, in the case of an accident or health plan, an employee who receives coverage both for himself and any member of his family is to be treated as having received two separate coverages: individual coverage with respect to himself, and family coverage with respect to his family. Each coverage must be tested separately.

Single plan

Two or more plans that are identical in all respect, except for the group of employees covered, may be treated as a single plan.

The committee also intends that, for purposes of determining what constitutes a single plan, employees should be allowed to structure options in different ways as long as all coverage within a plan is identical. For example, if the deductible for all highly compensated employees is $200 and the deductible for all nonhighly compensated employees is $50, it would be inconsistent with the purposes of these amendments to classify the $200 deductible coverage as a separate plan that covers only highly compensated employees and thus is discriminatory. Instead, the employer could classify the coverage as one plan for all employees providing coverage for expenses in excess of a $200 deductible and a second plan covering costs between $50 and $200 covering only nonhighly compensated employees. Both such plans would be nondiscriminatory.

Aggregation of health plans and comparability

If an accident or health plan standing alone would fail the reasonable classification test or the percentage test, the plan may be aggregated with one or more other health or accident plans ("helper plans"), provided that the average value of the employer-provided coverage per employee in each "helper plan" is at least 90 percent of the average value of employer-provided coverage per covered employee in the plan that would otherwise fail.

The coverage rules may not be applied to a plan on a line of business or operating unit basis unless the plan satisfies the classification test of 410(b)(1)(B) as in effect immediately before the date of enactment of the Tax Reform Act of 1986 ("classification test"). In addition, a prerequisite to a plan's use of the average benefit test is the plan's satisfaction of the classification test. In the case of an accident or health plan that would otherwise fail the classification test, the plan may be aggregated with one or more other accident or health plans ("helper plans"), provided that the average value of the employer-provided coverage per employee in each "helper plan" is at least 100 percent of the value of employer-provided coverage per covered employee in the plan that would otherwise fail the classification test.

The bill provides that an accident or health plan will not be treated as failing to meet the nondiscrimination requirements merely because benefits provided under the plan are coordinated (in a manner that does not discriminate in favor of highly compensated employees) with health benefits provided under any Federal, State or foreign law or under any other health plan covering the employee or family member of the employee. Similarly, a plan that provides disability benefits that are subject to nondiscrimination rules will not be treated as discriminatory if the plan benefits provided to an employee are coordinated (in a manner that does not discriminate in favor of highly compensated employees) with disability benefits provided under any Federal, State, or foreign law, or under any other plan covering the employee.

Concentration tests

Accident or health plans and group-term life insurance plans

The bill establishes a new concentration test for all accident or health plans and group-term life insurance plans of an employer. Under the bill, no more than 40 percent of the employees benefiting under such a plan may be highly compensated employees. A plan is not treated as failing to meet this requirement if it benefits all employees of the employer.

The bill also establishes a second new concentration test for group-term life insurance plans. Under the bill, no more than 25 percent of the value of the coverage provided under the plan may be provided to individuals who are at any time during the current or preceding year, 5 percent owners (within the meaning of section 416(i)(1)(B)(i)). A plan is not treated as failing to meet this requirement if the plan provides the same dollar amount of group-term life insurance coverage for each employee eligible to participate in the plan. A plan that fails an applicable concentration test is considered to be a discriminatory plan.

The new concentration tests apply to health plans and group-term life insurance plans in addition to the nondiscriminatory coverage rules applicable to those plans. A plan that fails an applicable concentration test is considered to be a discriminating plan.

Other Plans

The present-law concentration tests applicable to qualified group legal services plans, educational assistance programs, and dependent care assistance programs continue to apply to those types of plans in addition to the nondiscriminatory coverage requirements. Thus, regardless of whether a plan satisfies the relevant present law nondiscrimination rules, or the new average income exclusion test, the plan is also required to satisfy the applicable present law concentration tests. A plan that fails an applicable concentration test is considered to be a discriminatory plan.

Former employees

The bill provides that, except to the extent provided by regulations, rules similar to the nondiscriminatory coverage rules are to be applied separately to former employees. In applying the rules to former employees, the Secretary is to prescribe regulations under which certain special rules shall apply. Employers may generally restrict the class of former employees to be tested to those who have retired on or after a reasonable retirement age, or to those who have separated from service due to disability. In addition, employers may generally limit the class further to employees who have, for example, retired within a certain number of years. Finally, in testing whatever class of employees is chosen under the eligibility test, employers may make reasonable assumptions regarding mortality, so that they do not have to determine those former employees who are still alive.

Cafeteria plans

As outlined above, under the bill, a cafeteria plan will be considered discriminatory unless the plan satisfies (a) the nondiscrimination tests of present law applicable to cafeteria plans (sec. 125(b)(1)) or (b) the present law eligibility test and the average income exclusion test. The bill preserves the present-law concentration test applicable to such plans (sec. 125(b)(2)).

For purposes of applying the average income exclusion test to a cafeteria plan, all benefits offered under the cafeteria plan are aggregated and treated as if they were the same type of benefit, except that if the employer elects, health coverage provided for spouses or dependents of employees may be tested separately. If a cafeteria plan satisfies the average income exclusion test, each of the statutory employee benefit programs offered under the cafeteria plan is treated as meeting the average income exclusion test, but must separately satisfy any applicable concentration test.

For purposes of applying the average income exclusion test, a benefit plan that would be a cafeteria plan, but for the fact that an employee may not choose cash or a taxable benefit, is to be treated as a cafeteria plan.

The bill substitutes the new definitions of highly compensated employees and of excludable employees for those applicable to cafeteria plans under present law. In determining which employees

may be excluded, all benefits provided under the cafeteria plan are to be treated as the same type of benefit.

It is also intended that cafeteria plans may limit the elections by highly compensated employees of excludable benefits to the extent necessary to comply with the nondiscrimination rules.

Welfare benefit funds

The bill substitutes the new definitions of highly compensated employees and of excludable employees for those applicable to welfare benefit plans under present law.

Effective Date

The provisions are generally effective for years beginning after December 31, 1986.

The bill contains an exception to the new rules for certain group-term insurance plans. Under the bill, in the case of a plan described in section 223(d)(2) of the Tax Reform Act of 1984, such plan shall be treated as meeting the requirements of the new nondiscrimination rules with respect to individuals described in section 223(d)(2) of the Act. In addition, the bill provides that an employer may elect to exclude such individuals in applying the new nondiscrimination rules.

In addition, the bill provides a delayed effective date for church plans. Under the bill, such plans are not required to comply with the new nondiscrimination requirements until years beginning after December 31, 1988.

Revenue Effect

The provisions are estimated to increase fiscal year budget receipts by $66 million in 1987, $116 million in 1988, $128 million in 1989, $140 million in 1990, and $154 million in 1991.

2. Deductibility of Health Insurance Costs of Self-Employed Individuals (sec. 1261 of the bill and sec. 213 of the Code)

Present Law

Under present law, an employer's contribution to a plan providing accident or health benefits is excludable from an employee's income (sec. 106). No similar exclusion is provided for self-employed individuals (sole proprietors or partners).

Benefits actually paid to an employee under an accident or health plan generally are includible in the employee's gross income to the extent attributable to employer contributions (sec. 105(a)). Reimbursements for costs incurred for medical expenses (within the meaning of sec. 213) and disability benefit payments that compensate for permanent injury and are computed without reference to the period of absence from work are excluded from gross income (secs. 105(b) and (c)). However, in the case of self-insured medical reimbursement plans (sec. 105(h)), no exclusion is provided for benefits paid to any employee who is among the 5 highest-paid officers, a 10-percent shareholder, or among the 25-percent highest-paid employees if the program discriminates in favor of this group as to

either eligibility to participate or the medical benefits actually provided under the plan.

Individuals who itemize deductions may deduct amounts paid during the taxable year, if not reimbursed by insurance or otherwise, for medical care of the taxpayer and of the taxpayer's spouse and dependents, to the extent that the total of such expenses exceeds five percent of adjusted gross income (sec. 213).

Medical care expenses eligible for the deduction are amounts paid by the taxpayer for (1) health insurance (including employee contributions to employer health plans); (2) diagnosis, treatment, or prevention of disease or malfunction of the body; (3) transportation primarily for and essential to medical care; and (4) lodging away from home primarily for and essential to medical care, up to $50 per night. The cost of a medicine or a drug is a medical care expense if it has been prescribed by a physician or is insulin.

Reasons for Change

The committee believes the present-law rules relating to the exclusion from income for benefits under employer accident or health plans create unfair distinctions between self-employed individuals (the owners of unincorporated businesses) and the owners of corporations. The ability to exclude health benefits to the extent provided by a corporate employer creates tax incentives for incorporation that the committee believes leads to inefficient tax-driven decision making.

More importantly, the committee is aware that access to employer health plans is lowest with small employers (particularly with small, self-employed employers). The need for adequate health coverage is so important that the committee believes it is essential to encourage a narrowing of the gap in health coverage. The committee concludes that a partial exclusion for health plans maintained by self-employed individuals will accomplish this goal.

However, the committee also believes this exclusion for the self-employed is not justified unless nondiscriminatory health insurance coverage is also extended to all employees of an unincorporated employer. To facilitate implementation of these nondiscrimination rules, the committee finds it desirable to direct the Secretary to provide simplified guidance for small employers.

Explanation of Provision

The bill provides a deduction for 50 percent of the amounts paid for health insurance for a taxable year on behalf of a self-employed individual and the individual's spouse and dependents. This deduction is allowable in calculating adjusted gross income. A self-employed individual means an individual who has earned income for the taxable year (sec. 401(c)(1)). However, under the bill, no deduction is allowable to the extent the deduction exceeds the self-employed individual's net earnings from self employment (sec. 1402(a)) for the taxable year. In addition, no deduction is allowable for any taxable year for which the self-employed individual is eligible to participate (on a subsidized basis) in a health plan of an employer of the self-employed individual or such individual's spouse.

In addition, the deduction is not allowable unless (1) the self-employed individual provides coverage under one or more accident or health plans for all employees in all unincorporated trades or businesses with respect to which the self-employed individual is a 5-percent owner (as defined in sec. 416(i)), and (2) the nondiscrimination requirements (as modified by the bill) applicable to accident or health plans are satisfied with respect to each such plan tested as though all coverage for which a 50-percent deduction is allowable under this section were employer-provided. Of course, this requirement is inapplicable if no unincorporated trade or business with respect to which the self-employed individual is a 5-percent owner has employees other than the self-employed individual and such individual's family members.

Under the bill, the amount allowable as a deduction for health coverage for a self-employed individual is not also taken into account for purposes of determining the amount of any medical deduction to which the self-employed individual is entitled. Thus, such amounts deductible under this provision are not treated as medical expenses of the individual for purposes of determining whether the 10 percent of adjusted gross income threshold for the itemized medical expense deduction (sec. 213(a)) is met.

Finally, the bill provides that the amount deductible under this provision is not taken into account in computing net earnings from self-employment (sec. 1402(a)). Therefore, the amounts deductible under this provision do not reduce the income base for the self-employed individual's social security tax.

The bill directs the Secretary of the Treasury to provide guidance to self-employed individuals to whom this deduction applies with respect to the nondiscrimination requirements applicable to insured accident or health plans.

Effective Date

The provision is effective for taxable years beginning after December 31, 1986.

Revenue Effect

The provision is estimated to decrease fiscal year budget receipts by $255 million in 1987, $348 million in 1988, $373 million in 1989, $424 million in 1990, and $481 million in 1991.

3. Exclusions for Educational Assistance Programs and Qualified Group Legal Plans Made Permanent (sec. 1262 of the bill and secs. 120 and 1127 of the Code)

Present and Prior Law

Educational assistance

Under present law, an employee is required to include in income for income and employment tax purposes the value of educational assistance provided by an employer to the employee, unless the cost of such assistance qualifies as a deductible job-related expense of the employee. Amounts expended for education qualify as deductible employee business expenses if the education (1) maintains

or improves skills required for the employee's job, or (2) meets the express requirements of the individual's employer that are imposed as a condition of employment. Under prior law, an employee's gross income for income and employment tax purposes did not include amounts paid or expenses incurred by the employer for educational assistance provided to the employee if such amounts were paid or such expenses were incurred pursuant to an educational assistance program that met certain requirements (Code sec. 127).

Under prior law, the maximum amount of educational assistance benefits that an employee could receive tax-free during any taxable year was limited to $5,000 so that the excess benefits over this amount were subject to income and employment taxes. In the case of an employee who worked for more than one employer, the $5,000 cap applied to the aggregate amount of educational assistance benefits received from all employers.

Amounts expended for education that may be deducted by the employee as an employee business expense were not subject to the $5,000 cap on educational assistance benefits and were not counted in determining whether other educational benefits received during the year exceeded the cap.

Any employer maintaining an educational assistance plan during any year was required to file an information return with respect to the program at the time and in the manner required by Treasury regulations. The return was required to show (1) the number of employees of the employer, (2) the number of employees eligible to participate in the program, (3) the number of employees participating under the program, (4) the total cost of the plan during the year, and (5) the name, address, and taxpayer identification number of the employer and the type of business in which the employer is engaged.

In 1984, the Congress directed the Treasury Department to conduct a study of the effect of the exclusion for employer-provided educational assistance. A copy of the report, together with any recommendations by Treasury, was to be submitted to the Committee on Ways and Means of the House of Representatives, and the Committee on Finance of the Senate not later than October 1, 1985.

The exclusion for educational assistance benefits expired for taxable years beginning after December 31, 1985.

Group legal services

Under prior law, amounts contributed by an employer to a qualified group legal services plan for employees (or their spouses or dependents) were excluded from an employee's gross income for income and employment tax purposes (sec 120). The exclusion also applied to any services received by an employee or any amounts paid to an employee under such a plan as reimbursement for the cost of legal services for the employee (or the employee's spouse or dependents). In order to be a qualified plan under which employees were entitled to tax-free benefits, a group legal services plan was required to fulfill several requirements. An employer maintaining a group legal services plan was required to file an information return with respect to the program at the time and in the manner required by Treasury regulations.

In addition, under prior law, an organization, the exclusive function of which was to provide legal services or indemnification against costs of legal services as part of a qualified group legal services plan, was entitled to tax-exempt status (sec. 501(c)(20)). The tax exemption for such an organization expired for years ending after December 31, 1985.

The exclusion for group legal services benefits expired for taxable years ending after December 31, 1985.

Reasons for Change

The exclusions for educational assistance and group legal services were originally enacted in 1978 for a temporary period in order to provide Congress with an opportunity to evaluate the use and effectiveness of the exclusions. The committee believes that the effectiveness of these exclusions in encouraging employers to make such benefits available to employees has clearly been demonstrated.

Further, the committee is concerned that the practice in prior years of temporarily extending these exclusions has led to disruption of employers' employee benefit programs. These exclusions have been permitted to expire twice, only to be retroactively reinstated, leaving employers uncertain as to the possibility of further extensions. The employees of those employers who interpreted literally the expirations and withheld the value of these benefits from employees' wages were in effect penalized by the retroactive extensions. The committee finds this continuing uncertainty untenable and believes the exclusions should be made permanent.

Explanation of Provision

Permanent extensions

The bill retroactively makes permanent the exclusions from gross income for educational assistance and group legal services and the tax exemption for qualified group legal services organizations.

Increased cap on educational assistance

In addition, the bill increases the cap on annual excludable educational assistance benefits to $5,250 from $5,000. This cap is indexed, under the bill, by reference to the method, as of May 1, 1986, for determining percentage increases in the social security taxable wage base.

Effective Date

The provisions are effective (1) in the case of educational assistance benefits, for taxable years beginning after December 31, 1985, and (2) in the case of group legal services benefits and the tax exemption for qualified group legal services organizations, for taxable years ending after December 31, 1985.

The bill provides a transition rule with respect to group legal services benefits provided under a cafeteria plan. Under the transition rule, the enactment of the bill is treated in the same manner as a change in family status under proposed Treasury regulations

relating to cafeteria plans. (Prop. reg. sec. 1.125-1). Thus, an employee will be permitted to revoke an election to take cash or a taxable benefit after the period of coverage has commenced and to make a new election with respect to the remainder of the period of coverage. This transition rule applies to an election made to revoke a prior benefit election if the new election is made (1) with respect to group legal services benefits and (2) within 60 days after the date of enactment of the bill.

Revenue Effect

The provisions are estimated to decrease fiscal year budget receipts by $376 million in 1987, and $319 million in 1988, $399 million in 1989, $460 million in 1990, and $489 million in 1991.

4. Tax Treatment of Qualified Campus Lodging (sec. 1263 of the bill and sec. 119 of the Code)

Present Law

Section 119 excludes from an employee's gross income the value of lodging provided by the employer if (1) the lodging is furnished for the convenience of the employer, (2) the lodging is on the business premises of the employer, and (3) the employee is required to accept the lodging as a condition of employment.

Several court decisions have held that on-campus housing furnished to faculty or other employees by an educational institution does not qualify for the section 119 exclusion. Therefore, the fair rental value of the housing (less any amounts paid for the housing by the employee) was includible in the employee's gross income and constituted wages for income tax withholding and employment tax purposes in those cases.[2]

Deficit Reduction Act of 1984

Section 531(g) of the Deficit Reduction Act of 1984 (P.L. 98-369) prohibited the Treasury Department from issuing, prior to January 1, 1986, any income tax regulations that would provide for inclusion in gross income of the excess of the fair market value of qualified campus lodging over the greater of (1) the operating costs paid in furnishing the lodging, or (2) the rent received. This moratorium on regulations applied only with respect to qualified campus lodging furnished after December 31, 1983 and before January 1, 1986.

Qualified campus lodging was defined as lodging furnished by a school, college, or university to any of its employees, including nonfaculty employees, or to the employee's spouse or dependents. The moratorium applied only with respect to employer-furnished lodging that is located on a campus of, or in close proximity to a

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[2] *Bob Jones Univ.* v. *U.S.*, 670 F.2d 167 (Ct. Cl. 1982); *Goldsboro Christian Schools, Inc.* v. *U.S.*, 79-1 CCH USTC para. 9266, E.D.N.C. 1978 (value of lodging furnished to faculty constitutes wages subject to income tax, FICA, and FUTA withholding, in light of "long and consistent history of regulations and rulings, expressly and explicitly applying withholding taxes to lodging not furnished for the employer's convenience****"), *aff'g* order entered in *Goldsboro Christian Schools, Inc.* v. *U.S.*, 436 F.Supp. 1314 (E.D.N.C. 1977), *aff'd* per curiam in unpublished opinion (4th Cir. 1981), *aff'd* 103 S.Ct. 2017 (1983); *Winchell* v. *U.S.*, 564 F.Supp. 131 (D.Neb. 1983) (value of campus home taxed to college president); and *Coulbourn H. Tyler*, 44 CCH Tax Ct. Mem. 1221 (1982).

campus of, the educational institution. Under the 1984 Act, the moratorium did not apply with respect to any amount of the value of lodging if such amount was treated as wages or included in income when furnished.

The purpose of providing for the moratorium in the 1984 Act was to allow further time for consideration of arguments by schools and universities that special tax rules governing treatment of housing furnished to their employees should be provided by statute.

Reasons for Change

The committee believes that valuation rules should be provided to resolve continuing disagreements between educational institutions and the Internal Revenue Service as to the tax treatment of qualified campus lodging.

Explanation of Provision

The bill provides that for Federal tax purposes, the fair market value of use (on an annualized basis) of qualified campus lodging furnished by, or on behalf of, an educational institution (within the meaning of sec. 170(b)(1)(A)(ii))[3] shall be treated as not greater than five percent of the appraised value for the lodging, but only if under rules prescribed by the Secretary an independent appraisal of the fair market value is obtained by a qualified appraiser. Thus, the appraiser must be qualified to make appraisals of housing, and the appraisal cannot be made by the employer institution or any officer, trustee, or employee thereof.

The committee does not intend that a new appraisal must be obtained each year. However, the committee intends that the appraisal must be reviewed annually, in a manner prescribed by the Secretary, but that such review should not impose undue cost on the educational institution.

Accordingly, under the safe-harbor valuation rule of the bill, if the rent paid for qualified campus lodging is equal to or exceeds on an annualized basis five percent of the value determined by such an appraisal, no amount is included, on account of such housing, in the employee's gross income for income tax purposes or in the wage or benefit base for social security and other employment tax purposes.

The provision applies to lodging furnished to any employee of the educational institution (or to the employee's spouse or dependents), including nonfaculty employees, for use as a residence, if the employer-furnished lodging is located on a campus of, or in the proximity of, the educational institution.

If no appraisal is obtained that meets the requirements of the provision, then the fair rental value for tax purposes is to be determined in the manner as would be done absent a special rule, taking into account all the relevant facts and circumstances. This

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[3] An educational organization is described in sec. 170(b)(1)(A)(ii) "if its primary function is the presentation of formal instruction and it normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on. The term includes institutions such as primary, secondary, preparatory, or high schools, and colleges and universities," and includes both public and private schools (Treas Reg. sec. 1.170A-9(b)(1)).

does not preclude a taxpayer whose appraisal is found defective from subsequently obtaining a qualified appraisal and using the safe-harbor rule. For purposes of applying the first sentence of this paragraph to determine the fair rental value of campus lodging, the average of the rentals paid by individuals (other than employees or students of the educational institution) during such year for lodging provided by the educational institution that is comparable to the campus lodging provided to the employee is to be considered the fair rental value.

The new provision relating to qualified campus lodging does not affect the applicability of section 119(a) to lodging that qualifies for the exclusion in section 119(a).

Effective Date

The provision applies for taxable years or periods beginning after December 31, 1985.

For prior taxable years, it is intended (1) that the IRS is to follow the safe-harbor valuation rule of the bill as if in effect for those years (except with respect to any amount of value of campus lodging that was treated by the taxpayer as wages or included in income when furnished), and (2) that the value of the property as assessed by State or local tax authorities for State or local property tax purposes is to be treated as if it were the value determined by a qualified appraisal.

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by less than $5 million annually.

5. Health Benefits for Retirees (sec. 1263 of the bill, sec. 560(b) of DEFRA, and sec. 419A of the Code)

Present Law

Under present law, special deduction timing rules and deduction limits govern the deductibility of employer contributions to a welfare benefit fund (sec. 419). Under these rules, contributions by an employer to such a fund are not deductible under sections 162 or 212, but if they would otherwise be deductible under either of those sections, the contributions will be deductible (within limits) for the taxable year in which such contributions are made to the fund.

The amount of the deduction otherwise allowable to an employer for a contribution to a welfare benefit fund for any taxable year may not exceed the qualified cost of the fund for the year. Present law defines the qualified cost of a welfare benefit fund for a year as the sum of (1) the qualified direct cost of the fund for the year and (2) the addition (within limits) to the qualified asset account under the fund for the year, reduced by (3) the after-tax income of the fund.

The qualified asset account under a welfare benefit fund consists of assets set aside to provide for the payment of disability benefits, medical benefits, supplemental unemployment compensation benefits, severance pay benefits, or life insurance benefits. Under

present law, an account limit is provided for the amount in the qualified asset account for any year.

The account limit for any taxable year may include a reserve to provide certain post-retirement medical benefits. The qualified asset account limits allow amounts reasonably necessary to accumulate reserves under a welfare benefit plan so that funding of post-retirement medical benefits with respect to an employee can be completed upon the employee's retirement. These amounts may be accumulated no more rapidly than on a level basis over the working life of an employee with the employer of that employee. Funding is considered level if it is determined under an acceptable funding method so that future post-retirement benefit and administrative costs will be systematically allocated ratably to future pre-retirement years.

Each year's computation of contributions with respect to retiree medical benefits is to be made under the assumption that the medical benefits provided to retirees will have the same cost as medical benefits currently provided to retirees. Because the reserve is computed on the basis of current medical costs, future inflation is not to be taken into account and it is to be assumed that the level of utilization will not increase in the future.

The Deficit Reduction Act of 1984 (DEFRA) directed the Secretary of the Treasury to study the possible means of providing minimum standards for employee participation, vesting, accrual, and funding under welfare benefit plans for current and retired employees (including separated employees). The study is to include a review of whether the funding of welfare benefits is adequate, inadequate, or excessive. The Secretary was required to report to the Congress with respect to the study by February 1, 1985, with suggestions for minimum standards where appropriate. This study has not yet been completed.

Reasons for Change

The committee believes that the current rules for funding of post-retirement medical benefits may result in less benefit protection for employees because an employer is required to fund retiree health benefits on the assumption that future costs will not exceed the current costs of such benefits. This rule may increase substantially the employer costs of funding as an employee nears retirement. The committee is also concerned that employers too frequently make unfunded promises to pay for medical benefits for retirees and that employees may be relying on such promises. Therefore, the committee finds it appropriate to improve the incentive for employers to fund post-retirement medical benefits over an employee's working career so that such funds are in fact available at retirement to provide the benefits.

In addition, the committee extends the due date of the study mandated by DEFRA of retiree benefits to reiterate to the Secretary of the Treasury its interest in obtaining this study.

Explanation of Provision

The bill provides that projected increases in medical costs may be taken into account in the funding for post-retirement medical

benefits. The amount of such projected increases that is to be used is determined under an index specified by the Secretary of the Treasury. Thus, under the bill, the account limit for post-retirement medical benefits under a welfare benefit fund is not limited to the projected costs of such benefits assuming no increase in medical costs until such increases occur. The Secretary is directed to publish an index for employers to use within 6 months after the date of enactment.

In addition, the bill extends the due date of the study of retiree benefits mandated by DEFRA to the date that is one year after the date of enactment of the bill.

Effective Dates

The provision relating to the funding of retiree medical benefits is effective for taxable years beginning after December 31, 1986. The extension of the due date of the study required by DEFRA is effective on the date of enactment.

Revenue Effect

The provision is estimated to decrease fiscal year budget receipts by $5 million for 1987, $13 million for 1988, $20 million for 1989, $25 million for 1990, and $30 million for 1991.

6. Accrued Vacation Pay (sec. 325 of the bill and sec. 463 of the Code)

Present Law

Under present law, an accrual-method taxpayer generally is permitted a deduction in the taxable year in which all the events have occurred that determine the fact of a liability and the amount thereof can be determined with reasonable accuracy (the "all-events" test). In determining whether an amount has been incurred with respect to any item during the taxable year, all events that establish liability for such amount are not treated as having occurred any earlier than the time economic performance occurs (sec. 461(h)). With respect to a liability that arises as a result of another person's providing services to the taxpayer (such as the liability to provide vacation pay in exchange for services by an employee), economic performance generally occurs when such other person provides the services.

Under present law, an exception applies under which certain expenses may be treated as incurred in the taxable year in which the "all-events" test is otherwise met even though economic performance has not yet occurred. This exception applies if four conditions are met: (1) the "all-events" test (determined without regard to economic performance) is satisfied with respect to the item during the taxable year; (2) economic performance occurs within a reasonable period (but in no event more than 8-1/2 months) after the close of the taxable year; (3) the item is recurring in nature and the taxpayer consistently from year to year treats items of that type as incurred in the taxable year in which the all-events test is met; and (4) either (a) the item is not material, or (b) the accrual of the item in the year in which the all-events test is met results in a

better matching of the item with the income to which it relates than would result from accruing the item in the year in which economic performance occurs. This exception does not apply to workers' compensation or tort liabilities.

In order to ensure the proper matching of income and deductions in the case of deferred benefits (such as vacation pay earned in the current taxable year, but paid in a subsequent year) for employees, an employer generally is entitled to claim a deduction in the taxable year of the employer in which ends the taxable year of the employee in which the benefit is includible in gross income (sec. 404(b)).[4] Consequently, an employer is entitled to a deduction for vacation pay in the taxable year of the employer in which ends the earlier of the taxable year of the employee for which the vacation pay (1) vests (if the vacation pay plan is funded by the employer), or (2) is paid.

An exception to this rule applies to amounts that are paid within 2-1/2 months after the close of the taxable year of the employer in which the vacation pay is earned. Such amounts are not subject to the deduction-timing rules applicable to deferred benefits, but are subject to the general rules under which an employer is entitled to a deduction when economic performance occurs (i.e.,when the services of the employee for which vacation pay is earned are performed). Because amounts paid within 2-1/2 months after the close of the employer's taxable year generally will qualify for the exception to the economic performance requirements, such amounts generally will be deductible for the preceding taxable year (the year in which the vacation pay is earned).

Under a special rule of present law, an employer may make an election under section 463 to deduct an amount representing a reasonable addition to a reserve account for vacation pay (contingent or vested) earned by employees in the current year and expected to be paid by the close of that year or within 12 months thereafter. For example, in the case of a taxpayer who makes this determination at the end of a taxable year, the reasonable addition for the year is the amount necessary so that the balance in the account at the beginning of the next taxable year is the amount reasonably expected to be paid in that year. If the balance in the account, before any addition, is greater than this amount, no additional deduction is allowed. Certain rules also allow a deduction for reductions in certain suspense accounts.

Reasons for Change

The committee believes that the special provision (sec. 463) of present law, under which an employer is entitled to deduct reasonable additions to an account for earned vacation pay expected to be paid within 12 months following the close of the taxable year, is inconsistent with the general principle that no deduction should be provided for a deferred benefit until the employee includes the benefit in income. Moreover, the committee believes that the present-law treatment is inequitable because the rules for accrued vacation

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[4] Special deduction-timing rules apply to benefits provided under a qualified pension, profit-sharing, or stock bonus plan.

pay are more favorable than the rules that apply to other types of compensation or other types of deductible items. The committee believes that the deduction for vacation pay should be subject to no more generous treatment than other items. Consequently, the committee bill limits the deduction for additions to the reserve for vacation pay to amounts paid within 8-1/2 months following the close of the taxable year. The committee believes that, by permitting an employer to deduct amounts paid within 8-1/2 months after the close of the taxable year, sufficient flexibility is provided to employers to take account of year-end accruals and normal payroll practices.

Explanation of Provision

Under the bill, the special rule allowing a deduction for additions to a reserve account for vacation pay (sec. 463) is limited to the vacation pay that is paid during the current taxable year or within 8-1/2 months after the close of the taxable year of the employer with respect to which the vacation pay was earned by the employees.

Effective Date

The provision applies to taxable years beginning after December 31, 1986.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $90 million in 1987, $71 million in 1988, $19 million in 1989, $20 million in 1990, and $17 million in 1991.

G. Employee Stock Ownership Plans

An employee stock ownership plan ("ESOP") is a qualified stock bonus plan or a combination of a stock bonus and a money purchase pension plan which is designed to invest primarily in employer securities for the benefit of employees and which may be utilized as a technique of finance. The stock, which is held by one or more tax-exempt trusts under the plan, may be acquired through direct employer contributions or with the proceeds of a loan to the trust (or trusts). Gain realized on the sale of employer securities to an ESOP is generally taxed as capital gains.

1. Statement of Congressional Policy (sec. 1271 of the bill)

Under the bill, a statement of Congressional policy with respect to employee stock ownership is adopted. This statement points out that the Congress, in a series of applicable laws and under the bill, has reflected its interest in encouraging employee stock ownership plans (ESOPs) as a bold and innovative tool of corporate finance for purposes of strengthening the private free enterprise system. The statement describes the policy of the Congress that ESOPs be used in a wide variety of corporate financing transactions in order to encourage the participation of employees as beneficiaries of such transactions. The statement makes clear Congressional concern that the policy articulated by the Congress will be made unattainable by regulations and rulings that (1) characterize employee stock ownership plans as conventional retirement plans, (2) reduce the freedom of ESOPs and employers to take the necessary steps to utilize ESOPs in a wide variety of corporate financing transactions, and (3) impede the establishment and success of these plans.

The applicable laws that reflect the Congressional interest in ESOPs as a technique of corporate finance are the Regional Rail Reorganization Act of 1973, the Employee Retirement Income Security Act of 1974, the Trade Act of 1974, the Tax Reduction Act of 1975, the Tax Reform Act of 1976, the Revenue Act of 1978, the Regional Rail Reorganization Act Amendments of 1978, the Small Business Development Act of 1980, the Chrysler Loan Guarantee Act of 1980, the Northeast Rail Service Act of 1981, the Economic Recovery Tax Act of 1981, the Trade Adjustment Assistance Act Amendments of 1983, and the Deficit Reduction Act of 1984.

Due to the committee's approval of amendments changing the philosophy of many employee benefit plans, the committee believes it appropriate to restate the purpose of ESOPs as a technique of corporate finance and an employee benefit plan under ERISA designed to create a stock ownership interest for employees, thereby distinguishing it from other employee benefit plans which have as their principal purpose retirement income security. Subject to the fiduciary standards of ERISA, the committee intends that ESOPs be widely utilized as a technique of finance in a wide variety of corporate transactions, including transactions financing new capital

as well as those structured to transfer ownership of existing capital.

To that end, leveraged ESOPs are intended to encourage plan sponsors to utilize corporate credit (e.g., to pledge corporate assets) in such a fashion that employees have access to nonrecourse corporate debt (i.e., no personal liability for employees or the plan) for the acquisition by the plan of employer securities. Plan sponsors are encouraged to utilize dividends paid on such securities to repay ESOP loans and to provide an ownership income to participants and beneficiaries (sec. 404(k)). Similarly, rights acquired by the plan as dividend rights on employer securities may be held by the plan for the benefit of employees.

The committee is concerned that the ERISA regulatory agencies, in an attempt to treat ESOPs as conventional retirement plans under ERISA, may preclude employers from utilizing ESOPs as a financing technique and may preclude employees from becoming the beneficiaries of transactions that may otherwise be structured to transfer substantial employer ownership to non-employee investors. The committee recognizes that an ESOP's participation in such transactions may be dependent upon participation by equity investors. Thus, in determining the fair allocation of equity among investors, consideration should be given to the fact that an ESOP generally acquires its shares in return for a nonrecourse note or for debt secured by the employer while other investors generally invest cash, provided, however, that in no case should an ESOP pay more than fair market value for employer securities it acquires.

2. Repeal of Employee Stock Ownership Credit (sec. 1272 of the bill and sec. 41 of the Code)

Present Law

Overview

An ESOP under which an employer contributes employer securities (or cash with which to acquire employer securities) in order to qualify for a credit against income tax liability is referred to as a tax credit ESOP. A tax credit ESOP must satisfy additional special requirements relating to vesting, allocation of employer contributions, and certain distribution rules.

Limits on tax credits

A special tax credit is provided for employers maintaining qualifying tax credit ESOPs. This credit was initially investment based (and the plans were called TRASOPs due to their origin in the Tax Reduction Act of 1975), but generally effective after 1982 is payroll based (and the plans are called PAYSOPs).

For taxable years ending after December 31, 1982, an electing employer is allowed an income tax credit for contributions to a tax credit ESOP limited to a prescribed percentage of the aggregate compensation of all employees under the plan. For compensation paid or accrued in calendar years 1983 through 1987, the tax credit is limited to one-half of one percent of compensation. No tax credit is permitted for compensation paid or accrued in calendar years beginning after 1987.

No payroll-based tax credit is allowed for contributions to a plan if more than one-third of the employer's contribution for the year is allocated to the group of employees consisting of officers, 10-percent shareholders, or individuals whose compensation exceeds a specified limit (for 1986, $60,000) (sec. 415(c)(1)(A)).

The amount of the employer's income tax liability that can be offset by the payroll-based tax credit for contributions to a tax credit ESOP generally is limited to the first $25,000 of tax liability, plus 85 percent of the excess over $25,000 (sec. 38(c)).[1] If the tax credit exceeds the amount of tax liability against which the credit may be applied for a taxable year, certain carrybacks and carryforwards are provided.[2]

Reasons for Change

The committee is interested in retaining tax incentives for employee stock ownership plans (ESOPs). However, in evaluating the relative tax benefits provided for ESOPs, the committee concluded that other incentives (including the financing incentives added by the Deficit Reduction Act of 1984 (DEFRA)) are more important than the ESOP tax credits. Thus, in order to raise sufficient revenue to add additional tax incentives for ESOP financing and to expand the incentives added by DEFRA, the committee believes it is appropriate to repeal the special ESOP tax credit at the end of 1986.

Explanation of Provision

The bill repeals the special ESOP tax credit for compensation paid or accrued after December 31, 1986. Of course, credits to which an employer became entitled prior to January 1, 1987, are not affected by this provision.

Effective Date

The repeal of the payroll-based tax credit generally applies with respect to compensation paid or accrued after December 31, 1986.

3. Certain Additional Tax Benefits Relating To ESOPs (secs. 1273 and 1247 of the bill and secs. 133, 404, and 4979 and new sec. 2057 of the Code)

Present Law

Deduction for dividends paid on ESOP stock

As added by the Deficit Reduction Act of 1984 (DEFRA), present law permits an employer to deduct the amount of any dividends paid in cash during the employer's taxable year with respect to stock of the employer that is held by an ESOP (including a tax-

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[1] If the employer is a member of a controlled group of corporations, the $25,000 amount against which the tax credit may be fully applied is reduced by apportioning such amount (pursuant to Treasury regulations) among the member corporations (sec. 38(c)(3)(B)).

[2] The unused tax credit may be carried back to each of the 3 preceding taxable years and carried forward to each of the 15 succeeding taxable years (sec. 39(a)). The amount of any unused credit that expires at the end of the last taxable year to which it may be carried is allowed as a deduction to the employer for such taxable year without regard to the usual limits on deductions for employer contributions to qualified plans (sec. 404(i)).

credit ESOP), but only to the extent the dividends are actually paid out currently to participants or beneficiaries (sec. 404(k)).

An employer is allowed a deduction for its taxable year in which the dividends are paid to participants. The deduction is allowed with respect to dividends that are (1) in accordance with the plan provisions, paid in cash directly to the participants, or (2) paid to the plan and subsequently distributed to the participants in cash no later than 90 days after the end of the plan year in which the dividends are paid to the plan.

For income tax purposes, dividends distributed under an ESOP, whether paid directly to participants pursuant to plan provisions or paid to the plan and distributed to participants, generally are treated as plan distributions. Such dividends do not qualify for the partial exclusion from income otherwise permitted under the Code (sec. 116).

Partial exclusion of interest earned on ESOP loans

A bank (within the meaning of sec. 581), an insurance company, or a corporation actively engaged in the business of lending money may exclude from gross income 50 percent of the interest received with respect to a securities acquisition loan made after July 18, 1984, and used to acquire employer securities after such date (sec. 133).

A securities acquisition loan is defined as a loan to a corporation or to an ESOP to the extent that the proceeds are used to acquire employer securities (within the meaning of sec. 409(1)) for the plan.

Reasons for Change

The committee believes that it is appropriate to expand on the incentives that advance the idea of broader capital ownership and employee stock ownership in particular and to make such incentives a permanent part of the Internal Revenue Code.

The committee felt it appropriate to encourage corporations to borrow money in order to make a contribution of stock to employees' accounts that could be immediately allocated (versus limiting the provision to those corporations utilizing a "leveraged ESOP" whereby employees' shares are held in a suspense account pending payment of the leveraged ESOP loan). It was felt that this approach would prove a valuable supplement to leveraged ESOPs by encouraging companies to borrow on behalf of their employees while ensuring that employees receive a stock allocation immediately and begin receiving dividend payments on such stock more rapidly.

The committee also believes it is appropriate to permit the interest income on securities acquisition loans qualified under section 133 to be received by the shareholders of regulated investment companies making such loans.

Further, in order to accelerate the repayment of ESOP loans, the committee finds it appropriate to permit a deduction for dividends on employer securities if such dividends are used to make payments on an ESOP loan.

Finally, to provide relief from estate taxes and to encourage the increased transfer of employer securities to ESOPs, the committee

provides a partial exclusion from an estate for the proceeds realized on an estate's sale of employer securities to an ESOP or to certain worker-owned cooperatives.

Explanation of Provisions

Estate tax exclusion for sales to employees

The bill permits an exclusion from the gross estate of 50 percent of the qualified proceeds from a qualified sale of employer securities. Under the bill, a qualified sale means any sale of employer securities (within the meaning of sec. 409(l)) by the executor of an estate to (1) an ESOP if the ESOP meets the requirements of section 409 or is described in section 4975(e)(7), or (2) an eligible worker-owned cooperative (as defined in sec. 1042(c)(2)).

Under the bill, qualified proceeds are defined to mean the proceeds received by the estate from the sale of employer securities issued by a domestic corporation if the sale occurs at any time before the due date of the estate tax return (including extensions of time to file). Qualified proceeds do not include the proceeds from the sale of any employer securities if the securities were received by the decedent (1) from a qualified plan (within the meaning of sec. 401(a)), or (2) as a transfer pursuant to an option or other right to acquire stock to which section 83, 422, 422A, 423, or 424 applies.

Under the bill, certain penalties apply if any portion of the assets attributable to employer securities acquired in a qualified sale accrue or are allocated for the benefit of (1) a decedent whose estate makes such a sale, (2) any person who is related to the decedent in one of the ways described in section 267(b), or (3) any other person who owns (after application of the attribution rules of sec. 318(a)) more than (a) 25 percent (by number) of any class of outstanding stock of the corporation (or certain related corporations) that issued such qualified securities, or (b) more than 25 percent of the total value of any class of outstanding stock of the corporation or of certain related corporations.

In addition, the bill makes it clear that this restriction applies to penalize any direct or indirect accrual of benefits under any qualified plan of the employer or an allocation of assets under the plan attributable to the securities involved in the qualified sale. Thus, for example, an ESOP in which the decedent has an interest should not allocate to the decedent's account any assets attributable to the securities involved in the sale. Nor should the employer make an allocation under the plan of other assets to the decedent in order to make up for the failure to allocate the securities involved in the qualified sale.

The bill clarifies that an individual is to be treated as a 25-percent shareholder only if the individual is a 25-percent shareholder (1) at any time during the one-year period ending on the date of a qualified sale to an ESOP, or (2) on the date upon which any of the securities sold to the ESOP in a qualified sale are allocated. In the case of an individual who satisfies the condition described at (1), the individual will continue to be treated as a 25-percent shareholder until all of the securities acquired pursuant to the qualified sale are allocated. In the case of an individual who does not satisfy the condition described at (1), but meets the condition described at

(2), the individual will be treated as a 25-percent shareholder only with respect to those securities allocated on the date or dates that the individual is a 25-percent shareholder.

The bill also provides that, for purposes of determining whether an individual owns more than 25 percent of the outstanding stock of the corporation which issued the employer securities, all allocated securities held by an ESOP are treated as securities owned by the ESOP participant to whom the securities are allocated. The treatment of shares held by an ESOP as held by a shareholder for purposes of applying the 25-percent test applies to qualified sales after the date of enactment.

Under the bill, individuals who would be ineligible to receive an allocation of securities *solely* because they are lineal descendants of the decedent may receive an allocation of the securities acquired in the qualified sale provided that the total amount of such securities allocated to all such lineal descendants is not more than 5 percent of all employer securities acquired in the qualified sale.

The bill would also provide that an ESOP that acquires securities in a qualified sale is required to provide that the restriction on the allocation of securities to the sellers, family members, and 25-percent shareholders will be satisfied. The sanction for failure to comply with the restriction would be disqualification of the plan with respect to those participants who received prohibited allocations. Thus, failure to comply would result in income inclusion for those participants of the value of their prohibited allocations as of the date of such allocations. However, violation of the restriction would not cause disqualification of the plan if the violation occurred more than 10 years after all of the securities acquired in the qualified sale had been allocated.

Under the bill, if there is a prohibited allocation by an ESOP or an eligible worker-owned cooperative of employer securities acquired in a qualified sale, then a 50 percent excise tax is imposed on the amount involved in the prohibited allocation. A prohibited allocation means (1) any allocation of employer securities acquired in a qualified sale if the provisions of section 409(n), relating to prohibitions on allocations to certain individuals, are violated, and (2) any benefit accruing to a person in violation of the provisions of section 409(n). The liability for this excise tax is to be paid by the employer who maintains an ESOP or by the eligible worker-owned cooperative.

Deduction for dividends paid on ESOP stock

Under the bill, the deduction for dividends paid on ESOP stock is expanded to apply to dividends that are used to repay ESOP loans. Such repayments are not treated differently from repayments attributable to nondeductible dividends for purposes of applying the limit on employer deductions (sec. 404(j)) or for purposes of applying the limitations on benefits and contributions (sec. 415).

Such dividends are deductible with respect both to allocated or unallocated employer securities, but only to the extent that such dividends are either paid out currently to employees or are used to repay acquisition indebtedness incurred to acquire the employer securities on which such dividends are paid.

Partial exclusion of interest earned on ESOP loans

The bill modifies the 50 percent exclusion for interest paid on securities acquisition loans (sec. 133) in two respects.

First, the bill provides that the exclusion is also available with respect to a loan to a corporation to the extent that, within 30 days, employer securities are transferred to the plan in an amount equal to the proceeds of the loan and such contributions are allocable to participants' accounts within one year after the date of the loan.

In addition, the original commitment period of the loan is not to exceed 7 years. Thus, provided the final maturity of the credit arrangement is not greater than 7 years, the funds may be provided by one or more lenders in a series of shorter maturity (back-to-back) loans, each of which (other than the first) is used to repay the preceding loan.

Second, under the bill, a lender eligible for the interest exclusion is amended to include a regulated investment company (as defined in sec. 851). The committee intends that the tax treatment accorded such income be permitted to "flow through" to shareholders of the regulated investment company under rules analogous to the treatment of interest paid on certain governmental obligations as described in section 103(a).

In determining whether a regulated investment company qualifies to pay exempt-interest dividends, one-half of the outstanding balance of such securities acquisition loans held by a regulated investment company is treated as obligations described in section 103(a)(1). One-half of the interest on such securities acquisition loans are treated as interest excludable under section 103(a) for purposes of determining the amount of exempt-interest dividends that the regulated investment company may pay.

The written notice of designation requirements applicable to exempt-interest dividends applies to dividends attributable to securities acquisition loans. The committee intends, however, that the regulated investment company include in such notice an explanation to shareholders that this income is partially excludable from tax because the interest thereon is utilized to repay a loan structured to acquire employer stock for employees through an employee stock ownership plan.

Effective Dates

The provision relating to the exclusion of 50 percent of the proceeds of a qualified sale from the gross estate is effective for sales after the date of enactment by the executor of an estate required to file a return (including extensions of time) to file after the date of enactment.

The provision relating to the deductibility of dividends is effective for taxable years beginning after the date of enactment. The provision relating to eligibility for the interest exclusion for securities acquisition loans is effective for loans used to acquire employer securities after the date of enactment. The changes in the treatment of securities acquisition loans are also available for loans used to refinance loans used to acquire employer securities before

the date of enactment, if such loans were used to acquire employer securities after July 18, 1984.

4. Changes in Qualification Requirements Relating to ESOPs (sec. 1275 of the bill and secs. 409 and 415 of the Code)

Present Law

Overview

Under present law, a pension, profit-sharing, or stock bonus plan (including an ESOP) is a qualified plan if it meets certain requirements of the Internal Revenue Code. A trust forming part of a qualified plan is exempt from tax if (1) employer contributions to the trust are made for the purpose of distributing the corpus and income to employees and their beneficiaries, and (2) under the trust instrument, it is impossible for any part of the trust corpus or income to be used for, or diverted to, purposes other than the exclusive benefit of employees before the liabilities to employees and their beneficiaries are satisfied. Benefits or contributions under a qualified plan are subject to standards designed to prohibit discrimination in favor of employees who are officers, shareholders, or highly compensated.

A qualified plan (including an ESOP) is required to meet minimum standards relating to coverage (the class of employees eligible to participate in the plan) (sec. 410), and vesting (the time at which an employee's benefit becomes nonforfeitable) (sec. 411(a)). Further, contributions or benefits must not exceed specified limits (sec. 415).

In addition to satisfying these general requirements, applicable to all qualified plans (sec. 401), ESOPs generally must satisfy special qualification requirements (sec. 409). The scope of these special rules differs depending on whether the plan is structured as a tax-credit ESOP. A tax-credit ESOP is an ESOP under which an employer contributes employer securities (or cash with which to acquire employer securities) in order to qualify for a credit against income tax liability.

Overall limits on contributions

In order to limit the extent to which individuals can use tax-favored arrangements to provide for employee benefits under a qualified plan, present law (sec. 415) provides overall limits on contributions and benefits under qualified pension, profit-sharing, and stock bonus plans. The overall limits apply to contributions or benefits provided to an individual under all qualified plans maintained by an employer or certain related employers.

Under a defined contribution plan (i.e., a money purchase pension, profit-sharing, or stock bonus plan), the present law imposes a limit on the annual additions with respect to each plan participant (sec. 415(c)). Under present law, the annual addition generally is limited to the lesser of (1) 25 percent of a participant's compensation for the year, or (2) $30,000. Beginning in 1988, the dollar limit is adjusted annually for post-1986 cost-of-living increases.

Present law provides a special limitation on annual additions under an ESOP (within the meaning of sec. 4975(e)(7)) or a tax credit ESOP (within the meaning of sec. 409). Under this special

rule, the usual dollar limit on annual additions ($30,000) is increased to the lesser of (1) $60,000 or (2) the amount of employer securities contributed to, or acquired by, the plan. In addition, deductible ESOP contributions applied by the plan to the payment of interest on a securities acquisition loan, as well as forfeitures of certain employer securities, may be disregarded in applying this limit.

These increased limits apply only if the ESOP provides that no more than one-third of the employer contributions for the year are allocated to the group of employees consisting of officers, 10-percent shareholders, and highly compensated employees (i.e., employees whose annual compensation exceeds twice the dollar limit on annual additions or $60,000).

Timing and form of distributions

In general

Unless an employee otherwise elects in writing, the payment of benefits from a qualified plan generally must begin no later than 60 days after the end of the plan year in which the employee attains the normal retirement age under the plan (or age 65, if earlier). The payment of benefits may be deferred beyond normal retirement age (or age 65, but not beyond the required beginning date under sec. 401(a)(9)) if the employee has not yet separated from the employer's service or has not yet completed 10 years of plan participation (sec. 401(a)(14)). In addition, employees may elect to further defer the commencement of benefits until the employee's required beginning date (sec. 401(a)(9)).

Benefits under a qualified stock bonus plan must be distributable at the employee's election in the form of employer securities or cash.

Special ESOP rules

A participant in a leveraged ESOP or a tax credit ESOP who is entitled to a distribution under the plan must be provided the right to demand that the distribution be made in the form of employer securities rather than in cash. Alternatively, subject to a participant's right to demand a distribution of employer securities, the plan may elect to distribute the participant's interest in cash, in employer securities, or in some combination of both cash and employer securities.

In addition, a participant who receives a distribution of employer securities from a tax credit ESOP or a leveraged ESOP must be given a put option with respect to distributed employer securities that are not readily tradable.[3] The distributee must be given at

[3] Present law provides certain exceptions to these rules requiring distributions of employer securities. First, an ESOP may preclude a participant from demanding a distribution in the form of employer securities if the employer's corporate charter (or bylaws) restricts the ownership of substantially all outstanding employer securities to employees or to a trust under a qualified plan. The ESOP must, however, provide that participants entitled to a distribution have a right to receive the distribution in cash. In addition, in the case of a tax credit ESOP or a leveraged ESOP established and maintained by a bank or similar financial institution which is prohibited by law from redeeming or purchasing its own securities, an exception is made to the rule generally requiring that a participant who receives a distribution of employer securities must be given a put option if the securities are not readily tradable. In such a case, a put option

Continued

least 60 days after receipt of the securities to require the employer to repurchase the securities at their fair market value. If the distributee does not exercise the initial put option, the option will temporarily lapse. After the end of the employer's taxable year in which the temporary lapse of a distributee's option occurs and following a determination of the value of the employer securities as of the end of that taxable year, the employer is required to notify each distributee who did not exercise the initial put option in the preceding year of the value of the employer securities as of the end of the taxable year. The distributee must then be given at least 60 days to require that the employer repurchase the employer securities. If the distributee does not exercise this put option, the option permanently lapses.

If the put is exercised, present law requires that the provision for payment by the employer be reasonable. If payment of the put option price is deferred, the deferral is considered reasonable only if (1) the employer provides adequate security and a reasonable rate of interest, and (2) the cumulative amount actually paid is not less, at any time, than the aggregate amount of reasonable periodic payments that, but for the deferral, would have been made. Reasonable periodic deferrals are defined as substantially level annual installments commencing within 30 days after the date on which the put option is exercised and generally ending not more than 5 years after the date of exercise. However, the deferral period may be extended to a date no later than the earlier of (1) 10 years from the date the put option is exercised or (2) the date the acquisition loan with which the securities were acquired is entirely repaid.

Distribution restrictions

Stock bonus plans

In general, a qualified stock bonus plan may distribute amounts attributable to employer contributions only after a fixed number of years, the attainment of a stated age, or upon the prior occurrence of an event such as a layoff, illness, disability, retirement, death, or separation from service. Amounts that are to be distributed after a fixed number of years must be held in trust for at least two years. Special rules further restrict distributions from a stock bonus plan that contains a cash or deferred arrangement. An ESOP that is structured as a stock bonus plan is subject to these restrictions (except dividends paid on ESOP stock as described in sec. 404(k)).

Qualified money purchase plans

A qualified money purchase pension plan may not distribute benefits before (1) the employee attains the normal retirement age or separates from service, (2) the employee becomes disabled or dies, or (3) the plan terminates. The money purchase pension plan portion of an ESOP that is structured as a combination of a stock bonus plan and money purchase pension plan is subject to these restrictions.

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is not required if the ESOP provides that participants entitled to a distribution from the plan have a right to receive the distribution in cash.

Special tax credit ESOP restrictions

In addition to satisfying general qualified plan requirements with respect to plan distributions, a tax credit ESOP must further restrict distributions. In general, employer securities allocated to an employee's account under a tax credit ESOP may not be distributed before the end of the 84th month after the month in which the securities are allocated. This limitation does not apply to distributions of securities in the case of the employee's separation from service, death, or disability.

In addition, the 84-month rule does not apply in the case of the direct or indirect transfer of a participant from the employment of a selling corporation to the employment of an acquiring employer where all (or substantially all) of the assets used by the selling corporation in a trade or business are sold to the acquiring employer. The 84-month rule is also waived for an employee of a subsidiary of a selling corporation, with respect to securities of the selling corporation, where the selling corporation disposes of its interest in a subsidiary and the employee continues in the employ of the subsidiary.

Reasons for Change

The committee bill substantially shortens the distribution period permissible under present law and amends the put option provisions to protect employees without endangering employers. The committee recognizes that employers must be permitted an extended period of time to make large payments and that requiring more rapid payment may jeopardize the company and undermine the value of accounts for other employees (for example, if the company encounters liquidity problems due to the need to make large payments to participants).

Similarly, the committee believes that enabling a sponsoring employer to disregard "loan shares" enables an employer to plan its ESOP loan repayment schedule (i.e., without liabilities triggered by stock repurchase obligations). The committee also recognizes that requiring security for such payments could endanger the company financially, such as in a case in which the employer's unpledged assets are insufficient to provide such security. The committee also believes such security is inappropriate because it entails substantial additional administrative expense (e.g., UCC filings) and elevates employees to the status of a secured creditor. In addition, the committee previously indicated (under the Revenue Act of 1978) that no security was required for payments limited to 5 years duration.

The bill also promotes administrative ease by ensuring that amounts can be distributed, transferred to another plan, or rolled over when a plan is terminated. The current distribution restriction for tax credit ESOPs requires an employer to maintain a tax credit ESOP until 84 months after the last date stock is allocated. This rule originated with the investment tax credit ESOP to ensure that distributions were coordinated with the 7-year investment tax credit recapture period, a concept with less relevance now that the ESOP credit is based on payroll. Thus, the committee saw no pur-

pose in restricting distributions or in otherwise limiting transfers or rollovers to other qualified plans upon plan termination.

Further, the committee believes that greater uniformity of provisions will reduce complexity in the tax laws. Therefore, the bill extends to stock bonus plans the put option requirements applicable to ESOPs and adopts, for purposes of the special section 415 limit for ESOPs, the uniform definition of highly compensated employees adopted generally under the bill.

Explanation of Provisions

Overview

Under the bill, additional requirements are provided for any ESOP (within the meaning of sec. 4975(e)(7) or sec. 409). These additional qualification requirements (1) permit distributions upon termination of an ESOP, (2) modify the distribution and put option requirements, and (3) modify the special limits on allocations of contributions to an ESOP to conform the definition of highly compensated employee to the new definition provided for qualified plans generally.

Distributions upon plan termination

The bill amends the tax credit ESOP distribution provisions to permit certain distributions upon plan termination. Thus, the 84-month rule generally will not apply with respect to distributions made on account of the termination of a tax-credit ESOP.

Distribution and put option requirements

Timing of distribution

The bill modifies the rules relating to the timing and form of required distributions. Under the bill, an ESOP is to permit distributions to employees who separate from service before normal retirement age. Unless an employee otherwise elects in writing, the payment of benefits under an ESOP must begin no later than one year after the later of the plan year (1) in which the participant terminates employment due to retirement, disability, or death, or (2) which is the fifth plan year following the participant's separation from service (provided the participant does not return to service with the employer prior to that time).

The bill provides an exception to the general rule on availability of a distribution in the case in which any portion of a participant's account balance is attributable to securities for which any portion of an acquisition indebtedness related to such securities is outstanding. Therefore, if a portion of a participant's account balance includes employer securities which were acquired in connection with a loan that has not been fully repaid, the exception applies. Under this exception, distributions are not required to be made available to a participant under the general rule until the plan year following the plan year in which the loan is fully repaid.

The rules added by the bill are intended as an acceleration of the otherwise applicable benefit commencement date. Accordingly, if the general rules (sec. 401(a)(14)) require the commencement of dis-

tributions at an earlier date, those general rules override this special ESOP rule.

Form of distribution

The bill generally retains the present-law requirement that a participant in an ESOP who is entitled to a distribution under the plan must be provided the right to demand that the distribution be made in the form of employer securities rather than in cash and the present-law requirement that a participant who receives a distribution of employer securities from a tax credit ESOP or a leveraged ESOP must be given a put option with respect to distributed employer securities that are not readily tradable. However, the bill modifies the permissible periods over which the employer may pay the option price to the participant. The modifications contained in the bill apply with respect to all ESOP distributions, not merely the accelerated distributions added by the bill.

Unless the plan provides that a participant may elect a longer distribution period, the plan is to provide distributions over a period not longer than 5 years. The bill extends this distribution period if the participant's account balance exceeds $500,000 by one year (up to 5 additional years) for each $100,000 (or fraction thereof) by which the account balance exceeds $500,000. These dollar amounts are indexed at the same time and in the same manner as the dollar limits on benefits under a defined benefit pension plan (sec. 415(d)).

In the case of a total distribution of employer securities to a participant that are put to the employer, the bill provides that the employer must pay the option price to the participant in substantially equal annual payments over a period not exceeding 5 years and beginning not more than 30 days after the exercise of the put option. The employer is not required to provide security with respect to such installment payments, but is required to credit a reasonable rate of interest with respect to the outstanding balance under such installment payments of the option price. A total distribution means the distribution within one taxable year of the recipient of the account balance under the plan.

In the case of a put option exercised as part of an installment distribution, the employer is required to pay the option price within 30 days after the exercise of the option.

Extension of put option requirements to stock bonus plans

Under the bill, distributions of nonreadily tradable securities of an employer from a stock bonus plan are subject to the put option requirements applicable to ESOPs.

Modification of limitations on annual additions for ESOPs

Under the bill, the definition of an employee who is subject to the one-third allocation limit for purposes of the special limitation on annual additions for ESOPs (sec. 415(c)(6)) is modified to conform to the new definition of highly compensated employee added under the bill for purposes of qualified pension, profit-sharing, or stock bonus plans, and for purposes of employee benefit plans.

Thus, under the bill, an employee is treated as highly compensated with respect to a year if, at any time during the year or the pre-

ceding year, the employee (1) was a 5-percent owner of the employer (as defined in sec. 416(i)); (2) earned at least $100,000 in annual compensation from the employer; (3) earned at least $50,000 in annual compensation from the employer and was a member of the top-paid group of the employer during the same year; or (4) was an officer of the employer (as defined in sec. 416(i)).

The bill provides that the top-paid group of employees includes all employees who are in the top 20 percent of all employees on the basis of compensation paid during the year. Under a special rule, an employer may elect to exclude certain employees in determining the size of the employer's workforce for purposes of calculating the top 20 percent of employees.

Further, the bill provides that an employee will not be treated as in the top-paid group in the current year unless such employee also is among the 100 employees who have earned the highest compensation during such year. Under this rule, an individual who was a highly compensated employee for the preceding year (without regard to this 100-employee rule) remains highly compensated for the current year. Thus, the 100-employee rule is intended as a rule of convenience to employers only with respect to new employees hired or employees with significant salary increases during the current year. If any newly hired employee is not within the top-100 employees by pay for the current year, then that employee is not treated as highly compensated for the year, but will be treated as highly compensated for the following year if the employee otherwise falls within the definition of highly compensated employees.

Under the bill, a special rule is provided for the treatment of family members of certain highly compensated employees. Under the special rule, if (1) a family member benefits under an ESOP, and (2) is a family member of either a 5-percent owner or one of the top 10 highly compensated employees by compensation, then any compensation paid to such family member and any employer contribution under the plan on behalf of such family member is aggregated with the amounts paid and contributed on behalf of the 5-percent owner or the highly compensated employee in the top 10 employees by pay. Therefore, such family member and employee are treated as a single highly compensated employee in applying the special nondiscrimination tests.

An employee who has separated from service continues to be treated as a highly compensated employee if the individual was a highly compensated employee when the employee separated from service with the employer. For purposes of this rule, an employee is treated as highly compensated if the individual was highly compensated at any time during the current or the preceding year.

Effective Dates

The provision permitting distributions upon plan termination generally is effective for termination distributions made after December 31, 1984. The provision limiting qualifying termination distributions to total distributions, however, applies for distributions made on account of terminations occurring after December 31, 1985.

The distribution and payment requirements are effective with respect to distributions attributable to stock acquired after the date of enactment. The extension of the put option requirement to stock bonus plans is effective for distributions attributable to stock acquired after the date of enactment. The modified definition of highly compensated employees is effective for years beginning after December 31, 1986.

Revenue Effect of Part G

The provisions are estimated to increase fiscal year budget receipts by $1,013 million in 1987, $879 million in 1988, $221 million in 1989, and $51 million in 1990, and to reduce fiscal year budget receipts by $40 million in 1991.

TITLE XIII—RESEARCH AND DEVELOPMENT

A. Incremental Research Tax Credit; University Basic Research Credit (Sec. 1301 of the bill and sec. 30 of the Code)

Present Law

Expensing

A taxpayer may elect to deduct currently the amount of research and experimental expenditures incurred in connection with its trade or business (sec. 174), notwithstanding the general rule that business expenditures to develop or create an asset that has a useful life extending beyond the taxable year must be capitalized. (Alternatively, the taxpayer may treat these expenditures as deferred expenses and deduct them over a period of not less than 60 months on a straight-line basis.) This provision was enacted in the 1954 Code in order to eliminate the need to distinguish research from business expenses for deduction purposes, and to encourage taxpayers to carry on research and experimentation activities.[1]

The Code does not specifically define "research or experimental expenditures" eligible for the section 174 deduction election, except to exclude certain costs. Treasury regulations (sec. 1.174-2(a)) define "research or experimental expenditures" to mean "research and development costs in the experimental or laboratory sense." The regulations provide that this includes generally "all such costs incident to the development of an experimental or pilot model, a plant process, a product, a formula, an invention, or similar property, and the improvement of already existing property of the type mentioned." Other research or development costs—i.e., research or developments costs not "in the experimental or laboratory sense"–do not qualify under section 174.

The present regulations provide that qualifying research expenditures do not include expenditures "such as those for the ordinary testing or inspection of materials or products for quality control or those for efficiency surveys, management studies, consumer surveys, advertising, or promotions." Also, the section 174 election cannot be applied to costs of acquiring another person's patent, model, production, or process or to research expenditures incurred in connection with literary, historical, or similar projects (Reg. sec. 1.174-2(a)).

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[1] H. Rpt. No. 1337, 83d Cong., 2d Sess. at 28 (1954); S. Rpt. 1622, 83d Cong., 2d Sess. at 33 (1954); *Snow* v. *Comm'r*, 416 U.S. 500 (1974) (citing Congressional intent to encourage research by both "oncoming" and "ongoing" businesses); *Green* v. *Comm'r*, 83 T.C. 667 (1984) (intent of sec. 174 was to encourage "up-and-coming" small businesses to engage in research, not to allow passive investor entities to obtain current deductions).

Incremental tax credit

Under a provision enacted in the Economic Recovery Tax Act of 1981, the taxpayer also may claim a nonrefundable 25-percent income tax credit for certain research expenditures paid or incurred in carrying on an existing trade or business (sec. 30). The credit applies only to the extent that the taxpayer's qualified research expenditures for the taxable year exceed the average amount of the taxpayer's yearly qualified research expenditures in the specified base period (generally, the preceding three taxable years). Under present law, the credit is not available for expenses paid or incurred after December 31, 1985.

Research expenditures eligible for the incremental credit consist of (1) in-house expenditures by the taxpayer for research wages and supplies used in research, plus certain amounts paid for research use of laboratory equipment, computers, or other personal property; (2) 65 percent of amounts paid by the taxpayer for contract research conducted on the taxpayer's behalf; and (3) if the taxpayer is a corporation, 65 percent of the taxpayer's expenditures (including grants or contributions) pursuant to a written research agreement for basic research to be performed by universities or certain scientific research organizations.

The credit provision adopts the definition of research used for purposes of the section 174 expensing provision, but subject to three exclusions: (1) expenditures for research which is conducted outside the United States; (2) research in the social sciences or humanities; and (3) research to the extent that it is funded by any grant, contract, or otherwise by another person (or any governmental entity).

Under present law, the incremental research credit is not subject to the general limitation on use of business credits (85% of tax liability over $25,000).

Reasons for Change

Four-year extension.—When the incremental research credit was enacted in 1981, the Congress expressed serious concern about the then substantial relative decline in total U.S. expenditures for research and experimentation. The purpose of enacting the credit was to encourage business firms to perform the research necessary to increase the innovative qualities and efficiency of the U.S. economy. An expiration date for the credit was deemed desirable in order to enable the Congress to evaluate the operation of the credit, and to determine whether it should be extended and what modifications would be necessary to make the credit more effective.

The committee believes that an additional four-year extension of the credit is desirable in order to obtain sufficient data and information to evaluate whether or not the credit should be further extended or modified.

Research definition for credit purposes.—After reviewing available information and testimony on the actual use of the credit to date, the committee believes that the statutory credit provision should set forth an express definition of qualified research expenses for purposes of the credit. The committee believes that the definition has been applied too broadly in practice, and some tax-

payers have claimed the credit for virtually any expenses relating to product development. According to early data on the credit, the Treasury has reported, many of these taxpayers do not engage in high technology activities.

The committee bill targets the credit to research undertaken for the purpose of discovering information that is technological in nature and the application of which is intended to be useful in developing a new or improved business component for sale or use in the taxpayer's trade or business. In addition, research will be eligible for the extended credit only where substantially all the activities undertaken in developing or improving the business item constitute elements of a process of experimentation relating to functional aspects of the business component. The bill provides exclusions from the credit for certain product development activities, and limits allowance of the credit for the costs of developing certain internal-use software to such software meeting a high threshold of innovation.

No inference is intended from the provisions of the bill defining research eligible for the credit as to the scope of the term "research or experimental" for purposes of the section 174 expensing deduction.

University basic research.—The committee believes it is desirable to provide increased tax incentives for corporate cash expenditures for university basic research where such expenditures do not merely represent a switching of donations from general university giving and where certain other maintenance-of-effort levels are exceeded.

Credit use limitation.—The committee believes that the general limitation on use of business credits (under the bill, 75 percent of tax liability over $25,000) should apply to the research credit.

Explanation of Provision

Four-year extension

The bill extends the incremental research tax credit for four additional years, i.e., for qualified research expenditures paid or incurred through December 31, 1989.

Definition of research for credit purposes

In general

As under present law, the bill limits research eligible for the incremental credit to research as defined for purposes of the section 174 expensing deduction, i.e., "research and development costs in the experimental or laboratory sense." Thus, for example, the credit is not available for (1) research or development costs not "in the experimental or laboratory sense," (2) expenditures "such as those for the ordinary testing or inspection of materials or products for quality control or those for efficiency surveys, management studies, consumer surveys, advertising, or promotions," (3) costs of acquiring another person's patent, model, production, or process, or (4) research expenditures incurred in connection with literary, historical, or similar projects (Treas. Reg. sec. 1.174-2(a)). The term research includes basic research.

Under the bill, research satisfying the section 174 expensing definition is eligible for the credit only if the research is undertaken for the purpose of discovering information (a) that is technological in nature, and also (b) the application of which is intended to be useful in the development of a new or improved business component of the taxpayer. In addition, such research is eligible for the credit only if substantially all of the activities of the research constitute elements of a process of experimentation for a functional purpose. The bill also expressly sets forth exclusions from eligibility for the credit for certain research activities that might otherwise qualify and for certain nonresearch activities.

Technological nature

The determination of whether the research is undertaken for the purpose of discovering information that is technological in nature depends on whether the process of experimentation utilized in the research fundamentally relies on principles of the physical or biological sciences, engineering, or computer science—in which case the information is deemed technological in nature—or on other principles, such as those of economics—in which case the information is not to be treated as technological in nature. For example, information relating to financial services or similar products (such as new types of variable annuities or legal forms) or advertising does not qualify as technological in nature.

Process of experimentation

The concept of "process of experimentation" means a process of scientific experimentation or engineering activities to design a business component where the design of the component as a whole is uncertain at the outset, but instead must be determined by developing one or more hypotheses for specific design decisions, testing and analyzing those hypotheses (through, for example, modeling or simulation), and refining or discarding the hypotheses as part of a sequential design process to develop the overall component.

Thus, for example, costs of developing a new or improved business component are not eligible for the credit if the method of reaching the desired objective (the new or improved product characteristics) is readily discernible and applicable as of the beginning of the research activities, so that true experimentation in the scientific or laboratory sense would not have to be undertaken to develop, test, and choose among viable alternatives. On the other hand, costs of experiments undertaken by chemists or physicians in developing and testing a new drug are eligible for the credit because the researchers are engaged in scientific experimentation. Similarly, engineers who design a new computer system, or who design improved or new integrated circuits for use in computer or other electronic products, are engaged in qualified research because the design of those items is uncertain at the outset and can only be determined through a process of experimentation relating to specific design hypotheses and decisions as described above.

Functional purposes

Under the bill, research relating to a new or improved function, performance, reliability, quality, or reduced cost is treated as conducted for a functional purpose. (Activities undertaken to assure achievement of the intended function, performance, etc. of the business component after the beginning of commercial production of the component do not constitute qualified experimentation.) The bill also provides that research relating to style, taste, cosmetic, or seasonal design factors is not treated as conducted for a functional purpose.

Application of tests

The term business component means a product, process, computer software, technique, formula, or invention that is to be held for sale, lease, or license, or is to be used by the taxpayer in a trade or business of a taxpayer. If the requirements described above are not met with respect to a product, etc. but are met with respect to one or more elements thereof, the term business component means the most significant set of elements of such product, etc. with respect to which all requirements are met.

Thus, the requirements are applied first at the level of the entire product, etc. to be offered for sale, etc. by the taxpayer. If all aspects of such requirements are not met at that level, the test applies at the most significant subset of elements of the product, etc. This "shrinking back" of the product is to continue until either a subset of elements of the product that satisfies the requirements is reached, or the most basic element of the product is reached and such element fails to satisfy the test. Treasury regulations may prescribe rules for applying these rules where a research activity relates to more than one business component.

Internal-use computer software

Under a specific rule in the bill, research with respect to computer software that is developed by or for the benefit of the taxpayer primarily for the taxpayer's own internal use is eligible for the credit only if the software is used in (1) qualified research (other than the development of the internal-use software itself) undertaken by the taxpayer, or (2) a production process that involves a component that qualifies for the credit (e.g., where the taxpayer is developing robotics and software for the robotics for use in operating a manufacturing process, and the taxpayer's cost of developing the robotics is eligible for the credit). Any other research activities with respect to internal-use software are ineligible for the credit except to the extent provided in Treasury regulations. Accordingly, the costs of developing software are not eligible for the credit where the software is used internally, for example, in general and administrative functions (such as payroll, bookkeeping, or personnel management) or in providing noncomputer services (such as accounting, consulting, or banking services), except to the extent permitted by Treasury regulations.

The committee intends and expects that these regulations will make the costs of technologically new or improved internal-use software eligible for the credit only if the taxpayer can establish, in

addition to satisfying the general requirements for credit eligibility, (1) that the software is innovative (as where the software results in a reduction in cost, or improvement in speed, that is substantial and economically significant); (2) that the software development involves significant economic risk (as where the taxpayer commits substantial resources to the development and also there is substantial uncertainty, because of technical risk, that such resources would be recovered within a reasonable period); and (3) that the software is not commercially available for use by the taxpayer (as where the software cannot be purchased, leased, or licensed and used for the intended purpose without modifications that would satisfy the first two requirements just stated).

In the case of computer software costs that are not disqualified under the specific rule in the bill, the eligibility of such costs for the credit is to be determined in the same manner as the eligibility of hardware product costs.

Excluded activities

The bill specifies that expenditures incurred in certain research, research-related, or nonresearch activities are excluded from eligibility for the credit, without reference to the requirements described above relating to technological information, process of experimentation, and functional purposes.

Post-research activities

The bill provides that activities with respect to a business component after the beginning of commercial production of the component cannot qualify as qualified research. Thus, no expenditures relating to a business component are eligible for the credit after the component has been developed to the point where it either meets the basic functional and economic requirements of the taxpayer for such component or is ready for commercial sale or use.

For example, the credit is not available for such expenditures as the costs of preproduction planning for a finished business component, "tooling-up" for production, trial production runs, "troubleshooting" involving detecting faults in production equipment or processes, accumulation of data relating to production processes, and the cost of "debugging" product flaws. The costs of any development of plant processes, machinery, or techniques for commercial production of a business component do not constitute qualified research. However, qualified research to develop a technologically new or improved manufacturing process, etc., may qualify for the credit.

By way of further illustration, the credit is not available for costs of additional clinical testing of a pharmaceutical product after the product is made commercially available to the general public. However, the clinical testing in the United States of a product prior to production for sale in this country, or clinical testing seeking to establish new functional uses, characteristics, indications, combinations, dosages, or delivery forms as improvements to an existing product, is eligible for the credit. Thus, research (e.g., body chemistry research) undertaken on a product approved for one specified indication to determine its effectiveness and safety for other potential indications is eligible for the credit. Similarly, testing a drug

currently used to treat hypertension for a new anti-cancer application, and testing an antibiotic in combination with a steroid to determine its therapeutic value as a potential new anti-inflammatory drug, would be eligible for the credit.

Adaptation

The bill provides that adaptation of an existing business component to a particular requirement or customer's need is not eligible for the credit. Thus, for example, the costs of modifying an existing computer software item for a particular customer are not eligible for the credit. However, the mere fact that an item is intended for a specific customer does not disqualify otherwise qualified research costs of the item (assuming that the research is not funded by the customer).

Surveys, studies, etc.

The bill provides that the credit is not available for the costs of efficiency surveys, management studies, management techniques, market research, market testing and development (including advertising or promotions), routine data collections, or routine or ordinary testing or inspection of materials or business items for quality control. Management techniques include such items as preparation of financial data and analysis, development of employee training programs and management organization plans, and management-based changes in production processes (such as rearranging work stations on an assembly line).

Duplication

The bill provides that the credit does not apply to research related to the reproduction of an existing business component (in whole or in part) of another person from a physical examination of the component itself or from plans, blueprints, detailed specifications, or publicly available information with respect to such component. While such "reverse engineering" activities thus are not eligible for the credit, the exclusion for duplication does not apply merely because the taxpayer examines a competitor's product in developing its own component through a process of otherwise qualified experimentation requiring the testing of viable alternatives and based on the knowledge gained from such tests.

Additional exclusions

The bill excludes from eligibility for the credit expenditures for research (1) that is conducted outside the United States; (2) in the social sciences (including economics, business management, and behavioral sciences), arts, or humanities; or (3) to the extent funded by any person (or governmental entity) other than the taxpayer, whether by grant, contract, or otherwise. Also, the costs of ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral (including oil and gas) are not eligible for the credit.[2]

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[2] However, expenses of developing new and innovative methods of extracting minerals from the ground may be eligible for sec. 174 elections (Rev. Rul. 74-67, 1974-1 C.B. 63). Also, certain expenses for development of a mine or other natural deposit (other than an oil or gas well) may be deductible under sec. 616.

Effect on section 174 definition

No inference is intended from the rules in the bill defining research for purposes of the incremental credit as to the scope of the term "research or experimental" for purposes of the section 174 expensing deduction.

University basic research credit

In general

Under present law, research expenditures entering into the computation of the incremental research credit include 65 percent of a corporation's expenditures (including grants or contributions) pursuant to a written research agreement for basic research to be performed by universities or certain scientific research organizations. Under the bill, a 20-percent tax credit applies to the excess of (1) 100 percent of corporate cash expenditures for university basic research over (2) the sum of (a) the greater of two fixed research floors plus (b) an amount reflecting any decrease in nonresearch giving to universities by the corporation as compared to such giving during a fixed base period, as adjusted for inflation.[3]

Qualifying expenditures

For purposes of credit, qualifying basic research expenditures are cash expenditures paid pursuant to a written agreement between the taxpayer corporation[4] and a university or certain other qualified organizations for basic research to be performed by the qualified organization (or by universities receiving funds through the initial recipient qualified organizations). Such corporate expenditures for university basic research are deemed to satisfy the trade or business test for the research credit, whether or not the basic research is in the same field as an existing trade or business of the corporation.

Under the bill, qualifying expenditures include both grants or contributions by the corporation that constitute charitable contributions under section 170, and also payments for contract research to be performed by the qualified organization on behalf of the corporation. Such expenditures are not eligible for a credit unless and until actually paid by the corporation to a qualified organization. Thus, an accrual-basis corporation may not claim the credit for amounts incurred, but not actually paid, for university basic research.

Under the bill, only cash payments may qualify as a basic research payment. No amount (basis or value) on account of contributions or transfers of property is eligible for either the incremental credit or the basic research credit, whether or not such property constitutes scientific equipment eligible for an augmented charitable deduction under section 170(e)(4).

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[3] The bill provides a single research credit, consisting of a 25-percent incremental component and a 20-percent university basic research component. For convenience, this report generally refers to these components as the incremental research credit and the university basic research credit.

[4] For this purpose, the term corporation does not include S corporations (sec. 1361(a)), personal holding companies (sec. 542), or service organizations (sec. 414(m)(3)).

As under present law, the term basic research is defined in the bill as any original investigation for the advancement of scientific knowledge not having a specific commercial objective; other than basic research in the social sciences, arts, or humanities and basic research conducted outside the United States are excluded.

Qualified organizations

To be eligible for a credit, the corporate expenditures must be for basic research to be conducted by a qualified organization. For this purpose, the term qualified organization generally includes colleges or universities, tax-exempt scientific research organizations, and certain tax-exempt conduit or grant organizations.

The first category of qualified organizations consists of educational institutions that both are described in section 170(b)(1)(A)(ii) and constitute institutions of higher education within the meaning of section 3304(f). The second category consists of tax-exempt organizations that (1) are organized and operated primarily to conduct scientific research, (2) are described in section 501(c)(3) (relating to exclusively charitable, educational, scientific, etc., organizations), and (3) are not private foundations. Also, certain tax-exempt grant funds that qualify under present law continue to qualify under the bill.

In addition, the bill treats as qualified any tax-exempt organization that is organized and operated primarily to promote scientific research by colleges or universities pursuant to written research agreements, that expends on a current basis substantially all its funds (or all the basic research payments received by it) through grants and contracts for basic research by colleges and universities, and that is either (a) described in section 501(c)(3) and is not a private foundation or (b) described in section 501(c)(6) (trade associations).

Computation rules for revised basic research credit

The university basic research credit applies to the excess of (1) 100 percent of corporate cash expenditures for basic research over (2) the sum of the minimum basic research amount plus the maintenance-of-effort amount.

The minimum basic research amount is the greater of two fixed floors—

(a) the average of all credit-eligible basic research expenditures under Code section 30(e)(1) (as in effect during the base period) for each of the three taxable years immediately preceding the taxable year beginning after December 31, 1983; or

(b) one percent of the average of the sum of all in-house research expenses, contract research expenses, and credit-eligible basic research expenditures under Code section 30(e)(1) (as in effect during the base period) for each of the three taxable years immediately preceding the taxable year beginning after December 31, 1983.

In the case of a corporation that was not in existence for at least one full taxable year during the fixed base period, the bill provides that the minimum basic research amount for the base period shall not be less than 50 percent of the basic research payments for the current taxable year. If the corporation was in existence for one

full taxable year or two full taxable years during the base period, the fixed floor is to be computed with respect to such year or years.

The maintenance-of-effort amount is the excess of the average of the nondesignated university donations paid or incurred by the taxpayer during the three taxable years immediately preceding the taxable year beginning after December 31, 1983, as adjusted under the bill to reflect inflation, over the amount of nondesignated university donations paid by the taxpayer in the taxable year. The term nondesignated university donation means all amounts paid by the taxpayer to all colleges or universities for which a charitable deduction was allowable and that were not taken into account in computing the research credit.

The amount of credit-eligible basic research expenditures to which the new credit applies does not enter into the computation of the incremental credit. The remaining amount of credit-eligible basic research expenditures—i.e., the amount to which the new credit does not apply—enters into the incremental credit computation (and in subsequent years enters into the base period amounts for purposes of computing the incremental credit).

Credit limitations

The bill makes the research credit subject to the general business credit limitation, as amended by the bill.

Effective Date

The extension of the credit is effective for taxable years ending after December 31, 1985. (Under the provision, the credit will not apply to amounts paid or incurred after December 31, 1989.) The other amendments made by section 1301 of the bill are effective for taxable years beginning after December 31, 1985.

Revenue Effect

The provision is estimated to decrease fiscal year budget receipts by $648 million in 1986, $1,325 million in 1987, $1,626 million in 1988, $1,839 million in 1989, $1,315 million in 1990, and $660 million in 1991.

B. Rule for Allocation of Research and Experimental Expenditures (Sec. 1303 of the bill and sec. 861 of the Code)

Present Law

Foreign tax credit and source rules

All income has either a U.S. source or a foreign source. The foreign tax credit can offset U.S. tax on foreign source taxable income, but not tax on U.S. source taxable income. (This is known as the foreign tax credit limitation.) A shift in the source of income from foreign to U.S. may increase U.S. tax by reducing the foreign tax credit limitation.

In determining foreign source taxable income for purposes of computing the foreign tax credit limitation, and for other tax purposes, Code sections 861-863 require taxpayers to apportion expenses between foreign source income and U.S. source income. A shift in the apportionment of expenses from U.S. to foreign source gross income decreases foreign source taxable income. This decrease may increase U.S. tax by reducing the foreign tax credit limitation.

Research and experimental expense allocation regulation

Treasury Regulation section 1.861-8 (published in 1977) sets forth detailed rules for allocating and apportioning several categories of expenses, including deductible research and experimental expenditures ("research expenses"). The regulation provides that research expenses are ordinarily considered definitely related to all gross income reasonably connected with one or more of 32 product categories based on two-digit classifications of the Standard Industrial Classification ("SIC") system. Research expenses are not traced solely to the income generated by the particular product which benefited from the research activity. Instead, these expenses are associated with all the income within the SIC product group in which the product is classified.

The Treasury regulation contemplates that taxpayers will sometimes undertake research solely to meet legal requirements imposed by a particular political entity with respect to improvement or marketing of specific products or processes. In some cases, such research cannot reasonably be expected to generate income (beyond de minimis amounts) outside that political entity's jurisdiction. If so, the associated research expense reduces gross income only from the geographic source that includes that jurisdiction.

After research expenses incurred to meet legal requirements are allocated under the above rule, any remaining research expenses are generally apportioned to foreign source income based on the ratio of total foreign source sales receipts in the SIC product group with which the expenses are identified to the taxpayer's total

worldwide sales receipts in that product group (the "sales" or "gross receipts" method). However, the regulation provides that a taxpayer using the sales method may first apportion 30 percent of research expense remaining after allocation to meet legal requirements exclusively to income from the geographic source where over half of the taxpayer's research and development is performed.

Thus, for example, a taxpayer which performs two-thirds of its research and development in the United States may automatically apportion at least 30 percent of its remaining research expense to U.S. source income. A taxpayer can choose to apportion to the geographic source where research and development is performed a percentage of research expense significantly greater than 30 percent if the taxpayer establishes that the higher percentage is warranted because the research and development is reasonably expected to have a very limited or long-delayed application outside that geographic source.

Alternatively, subject to certain limitations, a taxpayer may elect to apportion its research expense remaining after any allocation to meet legal requirements under one of two optional gross income methods. Under these optional methods, a taxpayer generally apportions its research expense on the basis of relative amounts of gross income from U.S. and foreign sources. If a taxpayer makes an automatic place-of-performance apportionment, the taxpayer may not use an optional gross income method.

The basic limitation on the use of the optional gross income methods is that the respective portions of a taxpayer's research expense apportioned to U.S. and foreign source income using these methods may not be less than 50 percent of the respective portions that would be apportioned to each income grouping using a combination of the sales and place-of-performance apportionment methods.

If this 50-percent limitation is satisfied with respect to both income groupings, the taxpayer may apportion the amount of its research expense that remains after allocation under the legal requirements test ratably on the basis of foreign and U.S. gross income. If the 50-percent limitation is not satisfied with respect to one of the income groupings, then the taxpayer apportions to the income grouping with respect to which the 50-percent limitation is not satisfied, 50 percent of the amount of its research expense which would have been apportioned to that income grouping under the sales and place-of-performance methods. A taxpayer electing an optional gross income method may be able then to reduce the amount of its research expense apportioned to foreign source income to as little as one-half of the amount that would be apportioned to foreign source income under the sales method.

For example, consider a taxpayer with $110 of U.S.-performed research expense and equal U.S. and foreign sales. Assume that $10 of the research expense is to meet U.S. legal requirements and is allocated to U.S. source income. Of the remaining $100, 30 percent ($30) is exclusively apportioned to U.S. source income under the automatic place-of-performance rule and the remaining $70 is divided evenly between U.S. and foreign source income, using the sales method. Under the optional gross income methods, the $35 of research expense allocated to foreign sources could be reduced as

much as 50 percent, to $17.50. This could occur, for example, if the foreign sales were made by a foreign subsidiary that did not repatriate earnings to the U.S. corporation.

The optional gross income methods apply to all of a taxpayer's gross income, not gross income on a product category basis.

Temporary moratorium and Treasury study

The Economic Recovery Tax Act of 1981 (ERTA) provided that, for a taxpayer's first two taxable years beginning after the date of its enactment (August 13, 1981), all research and experimental expenditures (within the meaning of sec. 174) paid or incurred in those years for research activities conducted in the United States were to be allocated or apportioned to income from sources within the United States (sec. 223 of ERTA).

This two-year moratorium was effectively extended for two additional years by the Tax Reform Act of 1984. Under section 126 of the 1984 Act, for taxable years beginning generally after August 13, 1983, and on or before August 1, 1985, all of a taxpayer's research and experimental expenditures (within the meaning of sec. 174) attributable to research activities conducted in the United States are to be allocated to sources within the United States for purposes of computing taxable income from U.S. sources and from sources partly within and partly without the United States.

One reason the Congress cited for enacting the original two-year moratorium was that some foreign countries do not allow deductions under their tax laws for expenses of research activities conducted in the United States. Taxpayers argued that this disallowance caused U.S.-based research to be disadvantaged. First, U.S.-based research expense is deemed to be allocated to a foreign country which may not recognize that such amount is deductible as an expense. Second, at the same time the allocation of this U.S.-based research expense to foreign sources will reduce the U.S. taxpayer's foreign tax credit. Because those taxpayers could take their deductions if the research occurred in the foreign country, taxpayers argued that there was incentive to shift their research expenditures to those foreign countries whose laws disallow tax deductions for research activities conducted in the United States but allow tax deductions for research expenditures incurred locally.

Accordingly, the Congress concluded that the Treasury Department should study the impact of the allocation of research expenses under Treas. Reg. sec. 1.861-8 on U.S.-based research activities and on the availability of the foreign tax credit. Pending the outcome of the study, the Congress concluded that expenses should be charged to the cost of generating U.S. source income, whether such research was a direct or indirect cost of producing foreign source income.

On the ground that a reduction in research and development might adversely affect the competitive position of the United States, the 1983 Treasury report recommended the two-year extension of the moratorium that was ultimately enacted by the Congress in 1984. The extension was intended to allow the Congress to consider further the results of the Treasury study on the Treasury research expense allocation rules.

The Consolidated Omnibus Budget Reconciliation Act of 1985 (P.L. 99-272) extended the moratorium on the application of the research and experimental expense allocation rules of Treas. Reg. sec. 1.861-8 generally for one additional taxable year beginning after August 1, 1985, and on or before August 1, 1986.

Reasons for Change

The moratorium on the application of the Treasury research expense allocation rules was intended to encourage the performance of research in the United States. The committee strongly believes that the Federal tax law should generally encourage U.S.-based research activity.

Because of the importance of U.S.-based research activity, the committee will continue to study whether any additional permanent tax incentives for U.S. research might be appropriate. The committee considers it important that the relative equity and efficiency of alternative tax incentives be fully analyzed before any decision is made to adopt an additional permanent tax incentive. While the committee and the Congress study these issues further (for a one-year period), the bill provides temporary rules for allocation of research expense that are based on the approach of the Treasury regulation, but that liberalize the Treasury regulation in certain respects.

One concern the committee has with the Treasury regulation is its incompatibility with foreign tax systems. The committee does not feel that U.S.-based research expense should be deemed to be allocated to a foreign country when such research expense will be denied a deduction in such country. The committee believes that legislative intervention is appropriate until the incompatibility is resolved.

The committee is not persuaded by the argument that any liberalization of the allocation rule will only benefit companies with excess foreign tax credits. Many companies are in excess credit positions for many other reasons than the allocation of research expense deductions. These companies are paying the price of high taxes in order to compete in the international arena, and the committee does not feel that they should be further penalized because they base their research activities in the United States.

For many taxpayers, these temporary rules will increase the portion of U.S.-based research expense allocable to U.S. source income over what that portion would be if the regulation were fully applicable. These temporary modifications to the regulation's allocation rules are intended to provide an additional tax incentive to conduct research in the United States while the Congress analyzes whether any additional permanent incentive is necessary.

Explanation of Provision

Under the bill, for taxable years beginning generally after August 1, 1986, and on or before August 1, 1987, the application of the Treas. Reg. sec. 1.861-8 research expense allocation rules is effectively liberalized in three respects. These liberalizations apply notwithstanding other changes made by the bill in the Code's expense allocation rules.

The bill retains the regulatory rule (Treas. Reg. sec. 1.861-8(e)(3)(i)(B)) under which research expenditures are allocated entirely to one geographic source if they were incurred to meet legal requirements imposed with respect to improvement or marketing of specific products or processes and cannot reasonably be expected to generate income (beyond de minimis amounts) outside that geographic source. For the specified one-year period, the bill provides that 75 percent of all remaining amounts allowable as a deduction for qualified research and experimental expenditures will be apportioned to U.S. source income and deducted from such income in determining the amount of taxable U.S. source income.

The bill thus has the effect of increasing the automatic place-of-performance apportionment percentage for U.S.-based research expense from 30 percent to 75 percent. Under the bill, a taxpayer will be able to automatically apportion to U.S. source income 75 percent of its U.S.-based research expense remaining after any allocation of such expense incurred to meet legal requirements.

The bill further provides that, for the specified one-year period, the portion of those amounts allowable as a deduction for qualified research and experimental expenditures that remains after any legal requirements allocation and the 75-percent automatic place-of-performance apportionment will be apportioned on the basis of sales or gross income. Thus, the bill's second effective liberalization of the regulation is to make automatic place-of-performance apportionment available temporarily to taxpayers who elect to apportion expenses using the optional gross income method, as well as to taxpayers choosing the standard sales method of apportionment. Third, the bill has the effect of temporarily suspending the regulatory rule that prohibits taxpayers from using the optional gross income method to reduce allocation of research expense to foreign source income by more than 50 percent over what the allocation to foreign source income would be under the standard sales method.

The temporary modifications made by the bill to the Treasury Regulation sec. 1.861-8 research expense allocation rules apply for purposes of computing taxable income from U.S. sources and from sources partly within and partly without the United States. The modifications apply only to the allocation of research and experimental expenditures for the purposes of geographic sourcing of income. They do not apply for other purposes, such as the computation of combined taxable income of a FSC (or DISC) and its related supplier. They also do not apply to any expenditure for the acquisition or improvement of land, or for the acquisition or improvement of depreciable or depletable property to be used in connection with research or experimentation.

Effective Date

The provision applies to taxable years beginning after August 1, 1986, and on or before August 1, 1987 only.

Revenue Effect

The provision is estimated to decrease fiscal year budget receipts by $452 million in 1987, and $237 million in 1988.

C. Treatment of Computer Software Royalties for Certain Tax Purposes (Sec. 1302 of the bill and secs. 543 and and 553 of the Code)

Present Law

Under present law, a corporation that is treated as a personal holding company is subject, in addition to the regular corporate tax, to a 50-percent tax on its undistributed personal holding company income for the taxable year. Generally, a personal holding company is a corporation at least 50 percent of the value of the stock of which is held by not more than five individuals, and at least 60 percent of the adjusted ordinary gross income of which is personal holding company income (sec. 542(b)). For the purpose of the stock ownership test, an individual is treated as owning the stock owned directly or indirectly by or for any family members or partners of the individual and also is treated as owning a proportionate share of stock owned by corporations or partnerships in which the individual is a stockholder or partner (sec. 544).

Personal holding company income generally includes passive-type income such as interest, dividends, and certain rents and royalties (sec. 543(a)). Exceptions are provided for certain rents and royalties where the corporation derives most of its income from such rents or royalties, has only limited amounts of other personal holding company income (or distributes most of such income), and incurs deductible expenses in amounts that reflect active business activity rather than the mere collection of passive income. Royalties relating to the use of computer software are not eligible for any of such exceptions.

Certain corporations are excepted from the definition of personal holding company. The excepted corporations include tax-exempt organizations, banks, domestic building and loan associations, life insurance companies, surety companies, foreign personal holding companies, lending or finance companies that meet certain active business or gross income tests, foreign corporations with no U.S. shareholders, small business investment companies licensed by the Small Business Administration, and corporations subject to the jurisdiction of the Bankrupcy Court (sec. 542(c)).

In general, the undistributed foreign personal holding company income of a foreign personal holding company is treated as having been distributed as a dividend on the last day of the corporation's taxable year and is included in the income of certain U.S. shareholders (sec. 551). In general, a foreign personal holding company is a corporation at least 60 percent of the gross income of which is foreign personal holding company income, and more than 50 percent (in value) of the stock of which was owned at any time during the taxable year directly or indirectly by or for not more than five

individuals who are citizens or residents of the United States (sec. 552).

Undistributed foreign personal holding company income generally is the corporation's taxable income with certain adjustments, less the deduction for dividends paid (sec. 556). Foreign personal holding company income includes royalties (sec. 553).

Reasons for Change

Since the present-law rules defining personal holding company income make no exceptions for any royalty income derived from the licensing of computer software, it is possible that a closely held corporation that is engaged in extensive business activities relating to the development and distribution of computer software would be subject to the personal holding company tax or the foreign personal holding company provisions unless it distributes its income to shareholders. The committee believes that it is inappropriate to apply the personal holding company tax or the foreign personal holding company provisions in this situation, and that an exception to the definition of personal holding company income and foreign personal holding company income analogous to those provided for rent and certain other types of royalties for purposes of the personal holding company tax should be provided.

Explanation of Provisions

Overview

Under the bill, certain royalties relating to computer software are not treated as personal holding company income or foreign personal holding company income. To qualify for this treatment, the recipient must (a) be actively engaged in the trade or business of producing, developing, or manufacturing computer software, (b) derive more than half of its income from software royalties, (c) incur substantial trade or business expenses, or research and development expenses, and (d) distribute most of its passive income other than software royalties.

Active business requirements

Under the bill, personal holding company income or foreign personal holding company income does not include certain computer software royalties. To qualify for the exception, four conditions must be met.

First, computer software royalties must be received by a corporation engaged in the active conduct of the trade or business of developing, manufacturing, or producing computer software; such computer software (a) must be developed, manufactured, or produced by such corporation (or its predecessor) in connection with such trade or business, or (b) must be directly related to such trade or business (the trade or business test). For this purpose, predecessor includes a partnership the partners of which developed software for the partnership and transferred their partnership interests to the corporation in exchange for substantially all of the corporation's stock.

Second, computer software royalties that meet the first requirement must make up at least 50 percent of the ordinary gross income (as defined in sec. 543(b)) of the taxpayer for the taxable year (the 50-percent test).

Third, the amount of expenses that are properly allocable to the active business of developing, producing, or manufacturing software and that are allowable to the taxpayer under section 162 (relating to trade or business expenses), section 174 (relating to research and development expenses), or section 195 (relating to amortization of start-up expenses), must equal or exceed 25 percent of the ordinary gross income of the taxpayer for the taxable year (the "25-percent test").[5] Alternatively, the average of such deductions for the period of five taxable years ending with the current taxable year (or such shorter period as the corporation may have been in existence) must equal or exceed 25 percent of the ordinary gross income of the taxpayer for such period.

In computing deductions under section 162, the taxpayer may not take into account payments for personal services rendered by the five shareholders holding the largest percentage (by value) of the outstanding stock of the corporation. In determining the five largest shareholders for this purpose, stock deemed to be owned by a shareholder solely by reason of attribution from a partner (under sec. 544(a)(2)) is not taken into account, and individuals holding less than five percent of the corporation's stock (by value) are not taken into account.

Fourth, the sum of dividends paid during the taxable year (under sec. 562), dividends considered paid on the last day of the taxable year (under sec. 563), and the consent dividends for the taxable year (under sec. 565) must equal or exceed the amount of the corporation's personal holding company income in excess of 10 percent of the ordinary gross income of the corporation. For purposes of this computation, however, personal holding company income does not include the computer software royalties taken into account for the 50-percent test, and also does not include interest income for the five-year period beginning with the commencement of the active computer software business, provided that the 50-percent test and the 25-percent test also are met in this period.

Special rule for affiliated groups

Under the bill, a special rule is provided in the case of computer software royalty income received by a member of an affiliated group. The bill provides that if a taxpayer who is a member of an affiliated group (within the meaning of sec. 1504(a)) receives royalties in connection with the licensing of computer software, and another member of the group meets the trade or business test, the 50-percent test, and the 25-percent test with respect to such software, then the taxpayer is treated as having met such requirements.

Other rules

Certain interest income of a specified broker-dealer in securities is not treated as personal holding company income. Rules similar

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[5] For purposes of this computation, any deduction specifically allowable under any section of the Code other than sec. 162 may not be treated as allowable under sec. 162.

to those for computer softare royalties are provided for royalties received from the licensing of medical research products by a specified corporation.

Effective Date

The provision is effective for royalties received before, on, or after December 31, 1986. The bill does not allow taxpayers to reopen any taxable years closed by the statute of limitations to claim refunds based on the provision.

Revenue Effect

The provision is expected to decrease fiscal year budget receipts by $47 million in 1987, $13 million in 1988, $14 million in 1989, $15 million in 1990, and $17 million in 1991.

TITLE XIV—TAX SHELTERS; REAL ESTATE; INTEREST EXPENSE

A. Limitations on Losses and Credits from Passive Activities (sec. 1401 of the bill and sec. 469 of the Code)

Present Law

In general, no limitations are placed on the ability of a taxpayer to use deductions from a particular activity to offset income from other activities. Similarly, most tax credits may be used to offset tax attributable to income from any of the taxpayer's activities.

There are some exceptions to this general rule. For example, deductions for capital losses are limited to the extent that there are not offsetting capital gains.[1] For purposes of the alternative minimum tax applying to individuals, expensed intangible drilling costs may be used to reduce net oil and gas income to zero, but may not offset other income of the taxpayer. Foreign tax credits may be used to reduce tax on foreign source income, but not U.S. source income. Research and development credits may be used by individuals to reduce tax liability attributable to research and development activities, but not taxes attributable to other income of the taxpayer.

In the absence of more broadly applicable limitations on the use of deductions and credits from one activity to reduce tax liability attributable to other activities, taxpayers with substantial sources of positive income are able to eliminate or sharply reduce tax liability by using deductions and credits from other activities, frequently by investing in tax shelters. Tax shelters commonly offer the opportunity to reduce or avoid tax liability with respect to salary or other positive income, by making available deductions and credits, possibly exceeding real economic costs or losses currently borne by the taxpayer, in excess or in advance of income from the shelters.

Reasons for Change

In recent years, it has become increasingly clear that taxpayers are losing faith in the Federal income tax system. This loss of confidence has resulted in large part from the interaction of two of the system's principal features: its high marginal rates (in 1986, 50 percent for a single individual with taxable income in excess of $88,270), and the opportunities it provides for taxpayers to offset income from one source with tax shelter deductions and credits from another.

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[1] In the case of an individual, a net capital loss of up to $3,000 is deductible. Net capital losses of corporations generally are not deductible.

The prevalence of tax shelters in recent years—even after the highest marginal rate for individuals was reduced in 1981 from 70 percent to 50 percent—has been well documented. For example, a recent Treasury study[2] revealed that in 1983, out of 260,000 tax returns reporting "total positive income"[3] in excess of $250,000, 11 percent paid taxes equaling 5 percent or less of total positive income, and 21 percent paid taxes equaling 10 percent or less of total positive income. Similarly, in the case of tax returns reporting total positive income in excess of $1 million, 11 percent paid tax equaling less than 5 percent of total positive income, and 19 percent paid tax equaling less than 10 percent of total positive income.[4]

Such patterns give rise to a number of undesirable consequences, even aside from their effect in reducing Federal tax revenues. Extensive shelter activity contributes to public concerns that the tax system is unfair, and to the belief that tax is paid only by the naive and the unsophisticated. This, in turn, not only undermines compliance, but encourages further expansion of the tax shelter market, in many cases diverting investment capital from productive activities to those principally or exclusively serving tax avoidance goals.

The committee believes that the most important sources of support for the Federal income tax system are the average citizens who simply report their income (typically consisting predominantly of items such as salaries, wages, pensions, interest, and dividends) and pay tax under the general rules. To the extent that these citizens feel that they are bearing a disproportionate burden with regard to the costs of government because of their unwillingness or inability to engage in tax-oriented investment activity, the tax system itself is threatened.

Under these circumstances, the committee believes that decisive action is needed to curb the expansion of tax sheltering and to restore to the tax system the degree of equity that is a necessary precondition to a beneficial and widely desired reduction in rates. So long as tax shelters are permitted to erode the Federal tax base, a low-rate system can provide neither sufficient revenues, nor sufficient progressivity, to satisfy the general public that tax liability bears a fair relationship to the ability to pay. In particular, a provision significantly limiting the use of tax shelter losses is unavoidable if substantial rate reductions are to be provided to high-income taxpayers without disproportionately reducing the share of total liability under the individual income tax that is borne by high-income taxpayers as a group.

The question of how to prevent harmful and excessive tax sheltering is not a simple one. One way to address the problem would be to eliminate substantially all tax preferences in the Internal

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[2] Treasury Department, "Taxes Paid by High-Income Taxpayers and the Growth of Partnerships," reprinted in IRS Statistics of Income Bulletin (Fall 1985), beginning at page 55.

[3] Total positive income was defined as the sum of salary, interest, dividends, and income from profitable businesses and investments, as reported on tax returns.

[4] Other studies have similarly reached the conclusion that tax shelters, by flowing through tax benefits to individuals with positive sources of income, have permitted some taxpayers with sizeable economic incomes substantially to reduce their tax liabilities. *See* Joint Committee on Taxation, *Tax Reform Proposals: Tax Shelters and Minimum Tax* (JCS-34-85), August 7, 1985.

Revenue Code. For two reasons, however, the committee believes that this course is inappropriate.

First, while the bill reduces or eliminates some tax preference items that the committee believes do not provide social or economic benefits commensurate with their cost, there are many preferences that the committee believes are socially or economically beneficial. This is especially true when such preferences are used primarily to advance the purposes upon which Congress relied in enacting them, rather than to avoid taxation of income from sources unrelated to the preferred activity.

Second, it would be extremely difficult, perhaps impossible, to design a tax system that measures income perfectly. For example, the statutory allowance for depreciation, even under the normative system used under the bill for alternative minimum tax purposes, reflects broad industry averages, as opposed to providing precise item-by-item measurements. Accordingly, taxpayers with assets that depreciate less rapidly than the average, or that appreciate over time (as may be the case with certain real estate), may engage in tax sheltering even under the minimum tax, unless Congress directly addresses the tax shelter problem.

Even to the extent that rules for the accurate measurement of income can theoretically be devised, such rules may involve undue complexity from the perspective of many taxpayers. For example, a system that required all taxpayers to use a theoretically pure accrual method of accounting (e.g., including unrealized appreciation, and allowing only the amount of depreciation actually incurred for each specific asset in each taxable year) would create serious difficulties in both compliance and administration.

However, when the tax system, in order to avoid such complexity, permits simpler rules to be applied (e.g., generally not taxing unrealized gain, and allowing depreciation based on broad industry averages), opportunities for manipulation are created. Taxpayers may structure transactions specifically to take advantage of the situations in which the simpler rules lead to undermeasurement or deferral of income.

The question of what constitutes a tax shelter that should be subject to limitations is closely related to the question of who Congress intends to benefit when it enacts tax preferences. For example, in providing preferential depreciation for real estate or favorable accounting rules for farming, it was not Congress's primary intent to permit outside investors to avoid tax liability with respect to their salaries by investing in limited partnership syndications. Rather, Congress intends to benefit and provide incentives to taxpayers active in the businesses to which the preferences were directed.

In some cases, the availability of tax preferences to nonparticipating investors has even harmed the industries that the preferences were intended to benefit. For example, in the case of farming, credits and favorable deductions have often encouraged investments by wealthy individuals whose principal or only interest in farming is to receive an investment return, largely in the form of tax benefits to offset tax on positive sources of income. Since such investors may not need a positive cash return from farming in order to profit from their investments, they have a substantial competitive advantage in relation to active farmers, who commonly

are not in a position to use excess tax benefits to shelter unrelated income. This has significantly contributed to the serious economic difficulties presently being experienced by many active farmers.

The availability of tax benefits to shelter positive sources of income also has harmed the economy generally, by providing a non-economic return on capital for certain investments. This has encouraged a flow of capital away from activities that may provide a higher pre-tax economic return, thus retarding the growth of the sectors of the economy with the greatest potential for expansion.

The committee believes that, in order for tax preferences to function as intended, their benefit must be directed primarily to taxpayers with a substantial and *bona fide* involvement in the activities to which the preferences relate. The committee also believes that it is appropriate to encourage nonparticipating investors to invest in particular activities, by permitting the use of preferences to reduce the rate of tax on income from those activities; however, such investors should not be permitted to use tax benefits to shelter unrelated income.

There are several reasons why it is appropriate to examine the materiality of a taxpayer's participation in an activity in determining the extent to which such taxpayer should be permitted to use tax benefits from the activity. A taxpayer who materially participates in an activity is more likely than a passive investor to approach the activity with a significant nontax economic profit motive, and to form a sound judgment as to whether the activity has genuine economic significance and value.

A material participation standard identifies an important distinction between different types of taxpayer activities. In general, the more passive investor is seeking a return on capital invested, including returns in the form of reductions in the taxes owed on unrelated income, rather than an ongoing source of livelihood. A material participation standard reduces the importance, for such investors, of the tax-reduction features of an investment, and thus increases the importance of the economic features in an investor's decision about where to invest his funds.

Moreover, the committee believes that restricting the use of losses from business activities in which the taxpayer does not materially participate against other sources of positive income (such as salary and portfolio income) addresses a fundamental aspect of the tax shelter problem. As discussed above, instances in which the tax system applies simple rules at the expense of economic accuracy encourage the structuring of transactions to take advantage of the situations in which such rules give rise to undermeasurement or deferral of income. Such transactions commonly are marketed to investors who do not intend to participate in the transactions, as devices for sheltering unrelated sources of positive income (e.g., salary and portfolio income). Accordingly, by creating a bar against the use of losses from business activities in which the taxpayer does not materially participate to offset positive income sources such as salary and portfolio income, the committee believes that it is possible significantly to reduce the tax shelter problem.

Further, in the case of a nonparticipating investor in a business activity, the committee believes that it is appropriate to treat losses of the activity as not realized by the investor prior to disposi-

tion of his interest in the activity. The effort to measure, on an annual basis, real economic losses from passive activities gives rise to distortions, particularly due to the nontaxation of unrealized appreciation and the mismatching of tax deductions and related economic income that may occur, especially where debt financing is used heavily. Only when a taxpayer disposes of his interest in an activity is it possible to determine whether a loss was sustained over the entire time that he held the interest.

The relationship to an activity of an investor who does not materially participate may be little different from the relationship of a shareholder to a corporation. So long as the investor retains an interest in the activity, any reduction in the value of such interest not only may be difficult to measure accurately, but has not been realized by the investor to a greater extent than in the context of a C corporation. In the case of a C corporation, losses and expenses borne by the corporation, and any decline in the value of the corporation's stock, do not give rise to the recognition of any loss on the part of shareholders prior to disposition of their stock.[5]

The distinction that the committee believes should be drawn between activities on the basis of material participation bears no relationship to the question of whether, and to what extent, the taxpayer is at risk with respect to the activities.[6] In general, the fact that a taxpayer has placed a particular amount at risk in an activity does not establish, prior to a disposition of the taxpayer's interest, that the amount invested, or any amount, has as yet been lost. The fact that a taxpayer is potentially liable with respect to future expenses or losses of the activity likewise has no bearing on the question whether any amount has as yet been lost, or otherwise is an appropriate current deduction or credit.

At-risk standards, although important in determining the maximum amount that is subject to being lost, are not a sufficient basis for determining whether or when net losses from an activity should be deductible against other sources of income, or for determining whether an ultimate economic loss has been realized. Congress' goal of making tax preferences available principally to active participants in substantial businesses, rather than to investors seeking to shelter unrelated income, can best be accomplished by examining material participation, as opposed to the financial stake provided by an investor to purchase tax shelter benefits.

In certain situations, however, the committee believes that financial risk or other factors, rather than material participation, should be the relevant standard. A situation in which financial risk is relevant relates to the oil and gas industry, which at present is suffering severe hardship due to the worldwide collapse of oil prices. The committee believes that relief for this industry requires that tax benefits be provided to attract outside investors. Moreover, the committee believes that such relief should be provided only with respect to investors who are willing to accept an unlimited

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[5] Gain of a C corporation, while generally not taxed to the shareholder prior to distribution, is taxed at the entity level upon recognition.

[6] The at-risk rules of present law, while important and useful in preventing overvaluation of assets, and in preventing the transfer of tax benefits to taxpayers with no real equity in an activity, do not address the adverse consequences arising specifically from such transfers to nonparticipating investors.

and unprotected financial risk proportionate to their ownership interests in the oil and gas activities. Granting tax shelter benefits to investors in oil and gas activities who did not accept unlimited risk, proportionate to their ownership investments in the activities, would permit the benefit of this special exception to be diverted unduly to the investors, while providing less benefit to oil and gas activities and threatening the integrity of the entire rule limiting the use of nonparticipatory business losses.

A further area in which the material participation standard is not wholly adequate is that of rental activities. Such activities predominantly involve the production of income from capital. For this reason, rental income generally is not now subject to the self-employment tax, whether or not the activity constitutes a trade or business (sec. 1402(a)(1)). Rental activities generally require less ongoing management activity, in proportion to capital invested, than business activities involving the production or sale of goods and services. Thus, for example, an individual who is employed full-time as a professional could more easily provide all necessary management in his spare time with respect to a rental activity than he could with respect to another type of business activity involving the same capital investment. The extensive use of rental activities for tax shelter purposes under present law, combined with the reduced level of personal involvement necessary to conduct such activities, make clear that the effectiveness of the basic passive loss provision could be seriously compromised if material participation were sufficient to avoid the limitations in the case of rental activities.

A limited measure of relief, however, is believed appropriate in the case of certain moderate-income investors in rental real estate, who otherwise might experience cash flow difficulties with respect to investments that in many cases are designed to provide financial security, rather than to shelter a substantial amount of other income.

Further, additional considerations apply in the case of limited partnerships. In order to maintain limited liability status, a limited partner generally is precluded from materially participating in the business activity of the partnership; in virtually all respects, a limited partner more closely resembles a shareholder in a C corporation than an active business entrepreneur. Moreover, limited partnerships commonly are used as vehicles for marketing tax benefits to investors seeking to shelter unrelated income. In light of the widespread use of limited partnership interests in syndicating tax shelters, the committee believes that losses from limited partnership interests should not be permitted, prior to a taxable disposition, to offset positive income sources such as salary.

Explanation of Provisions

1. Overview

The bill provides that deductions from passive trade or business activities, to the extent they exceed income from all such passive activities (exclusive of portfolio income), generally may not be deducted against other income. Similarly, credits from passive activities generally are limited to the tax allocable to the passive activi-

ties. Suspended losses and credits are carried forward and treated as deductions and credits from passive trade or business activities in the next year. Suspended losses from an activity are allowed in full when the taxpayer disposes of his entire interest in the activity.

The provision applies to individuals, estates, trusts, and personal service corporations. A special rule limits the use of passive activity losses against portfolio income in the case of closely held corporations. Special rules also apply to rental activities. Losses from working interests in oil and gas property are not limited by the provision. Losses and credits attributable to a limited partnership interest generally are treated as arising from a passive activity. The provision is effective for taxable years beginning after 1986, and is phased in over 5 years. It becomes fully effective for taxable years beginning in 1991 and thereafter.

Losses and credits from a passive activity (taking into account expenses such as interest attributable to acquiring or carrying an interest in the activity) may be applied against income for the taxable year from other passive activities or against income subsequently generated by any passive activity. Such losses (and credits) generally cannot be applied to shelter other income, such as compensation for services or portfolio income (including interest, dividends, royalties, and gains from the sale of property held for investment). For this purpose, property held for investment generally does not include an interest in a passive activity.

Salary and portfolio income are separated from passive activity losses and credits because the former generally are positive income sources that do not bear, at least to the same extent as other items, deductible expenses. Since salary and portfolio income are likely to be positive, they are susceptible to sheltering by means of investments in activities that give rise to tax benefits. The passive loss provision ensures that salary and portfolio income, along with other non-passive income sources, cannot be offset by tax losses from passive activities until the amount of such losses is determined upon disposition.

Under the provision, suspended losses attributable to passive trade or business activities are allowed in full upon a taxable disposition of the taxpayer's entire interest in the activity.[7] The full amount of gain or loss from the activity can then be ascertained. To the extent the taxpayer's basis in the activity has been reduced by suspended deductions, resulting in gain on disposition, the remaining suspended deductions will, in effect, offset such gain. However, the character of any gain or loss is not affected by this provision.

Passive activity

Under the bill, an activity generally is a passive activity if it involves the conduct of any trade or business, and if the taxpayer does not materially participate in the activity. A taxpayer who is

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[7] Gain recognized on a transfer of a partial interest in the passive activity, and gain (boot) on a tax-free transfer of an entire or partial interest, are treated as from a passive activity. Gain on such transfers may be offset by losses and credits from passive activities, but such transfers are not treated as dispositions triggering all suspended losses from the activity.

an individual materially participates in an activity only if he is involved in the operations of the activity on a regular, continuous, and substantial basis. Regardless of whether an individual directly owns an interest in a trade or business activity (e.g., as a proprietorship), or owns an interest in an activity conducted at the entity level by a passthrough entity such as a general partnership or S corporation, he must be involved in the operations of the activity on a regular, continuous, and substantial basis, in order to be materially participating.

In the case of a limited partnership interest, special considerations apply. The form of entity most commonly chosen to maximize tax benefits in a tax shelter investment has been the limited partnership. Moreover, since a limited partner generally is precluded from participating in the partnership's business if he is to retain his limited liability status, the committee believes it should not be necessary to examine general facts and circumstances regarding material participation in this context. Therefore, under the bill, a limited partnership interest is treated as intrinsically passive (except as provided in regulations). Portfolio income of a partnership, however, is not treated as passive (see sec. 3, below). The committee intends that a share of partnership income, or a guaranteed payment to a partner (including a limited partner) attributable to the performance of personal services is not to be treated as passive. Losses from trade or business activities that are allocable to a limited partnership interest are not permitted, prior to disposition, to be applied against any income other than income from passive activities.

A passive activity under the bill does not include a working interest in oil or gas property. Thus, an owner of a working interest in oil or gas property is permitted to deduct otherwise allowable losses attributable to the working interest whether or not he materially participates in the activity being conducted through the working interest.

A passive activity is defined under the bill to include any rental activity, whether or not the taxpayer materially participates. However, operating a hotel or other similar transient lodging, for example, where substantial services are provided, is not a rental activity. An activity as a dealer in real estate is also not generally treated as a rental activity.[8] Long-term rentals or leases of property (e.g., apartments, leased office equipment, or leased cars), on the other hand, generally are considered to be rental activities. Losses from rental activities are allowed against income from other passive activities, but not against other income.

Interest on debt secured by the taxpayer's residence or a second residence is not subject to limitation under the passive loss rule, so long as the debt is secured by a security interest perfected under local law. Thus, if a taxpayer rents out his vacation home and a portion of the mortgage interest is allocable to rental use of the

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[8] Under the at-risk rules as extended by the bill to the activity of holding real estate, the holding of real property includes the holding of personal property and the providing of services which are incidental to making real property available as living accommodations. Whether an activity constitutes the holding of real estate for purposes of the at risk rules is not determinative of whether it constitutes a rental activity under the passive loss rule.

home which would otherwise be treated as a passive activity, it is not subject to limitation under this provision.

Under the bill, an individual may annually deduct up to $25,000 of passive activity losses (to the extent they exceed income from passive activities) that are attributable to rental real estate activities in which the taxpayer actively participates. The $25,000 offset is not available to corporations. A taxpayer is not treated as actively participating in a rental real estate activity if he has less than a 10 percent interest in the activity. (In such situations, the taxpayer's management activity would relate predominantly to the interests of his co-owners, rather than to the management of his own interest.) He is not presumed to be actively participating, however, if he has a 10 percent or greater interest. As discussed below, the active participation requirement is different from the material participation standard, and generally does not require as much personal involvement.

The $25,000 allowance is phased out ratably as the taxpayer's adjusted gross income (determined without regard to passive activity losses) increases from $100,000 to $150,000. Thus, under this rule, a middle income taxpayer who has invested in a condominium apartment, for example, and whose involvement in the operations necessary to rent it and maintain it amounts to active participation, may deduct up to $25,000 per year of losses from the rental real estate activity.

The $25,000 allowance for rental real estate applies, in a deduction equivalent sense, to credits attributable to rental real estate activities as well. Under a special rule, the $25,000 allowance applies to low-income housing credits regardless of whether the taxpayer claiming the credit actively participates in the low-income housing activity (including in the case of a limited partner).

A single $25,000 amount (and phaseout thereof) applies on an aggregate basis to credits (including the low-income housing credit) and to deductions, as opposed to allowing a $25,000 amount for each. If the total net rental real estate losses and credits (deduction equivalents) exceed the $25,000 amount allowable against other income, the taxpayer generally must allocate pro rata first among all the losses (including real estate rental activity losses suspended in prior years), and then the credits, attributable to each separate activity, in determining which are treated as allowed. This allocation is necessary for purposes of determining the total suspended losses attributable to each activity, which are allowable in full upon a disposition of the taxpayer's entire interest in the activity.

Taxpayers subject to the rule

The passive loss rule applies to individuals, estates and trusts. The rule also applies to personal service corporations (without regard to whether employee/owners whose services are provided own 10 percent and without regard to certain limitations in the applicable attribution rules). The committee intends that taxpayers not be able to circumvent the passive loss rule merely by virtue of the form in which they conduct their affairs. Thus, the rule is designed to prevent the sheltering of income derived from an individual's personal services simply by incorporating as a personal serv-

ice corporation and acquiring tax shelter investments at the corporate level.

It is also not intended that incorporation of an individual's portfolio investments be available as a way to avoid the passive loss rule. For this reason, the passive loss rule, in modified form, also applies to closely held C corporations (other than personal service corporations) that are subject to the at-risk rules (generally, where 5 or fewer individuals, directly or indirectly, own more than 50 percent of the stock). Such C corporations may not offset losses or credits from passive activities against portfolio income. Such corporations may, however, offset passive losses and credits against active business income (i.e., trade or business income which is not from a passive activity). In determining whether a corporation materially participates in an activity, and hence whether the activity is a passive activity, the material participation in the corporation's activity of corporate employees and owners is examined. As is generally true under the passive loss rule, losses and credits from a non-passive trade or business activity are not subject to any special limitation.

2. Treatment of losses and credits

In general

Losses.—Losses arising from a passive activity generally are deductible only against income from that or another passive activity. Suspended passive activity losses for the year are carried forward indefinitely, but are not carried back, and are allowed in subsequent years against passive activity income. Suspended losses from an activity are allowed in full upon a taxable disposition of the activity, as discussed below.

If any passive losses are not deductible in any given year, the amount of the suspended losses from each passive activity is determined on a pro rata basis. With respect to each activity, the portion of the loss that is suspended, and carried forward, is determined by the ratio of net losses from that activity to the total net losses from all passive activities for the year. This allocation is necessary in order to determine the suspended losses for any particular activity, which are allowed in full upon a disposition.

In the case of the $25,000 allowance for passive losses from rental real estate activities in which an individual actively participates, a situation could arise in which losses would be allowable for the year under the passive loss rule, but the taxpayer has insufficient (or no) non-passive income against which to apply them. In such a case, the otherwise allowable rental real estate losses are thereupon treated as losses which are not from a passive activity. They are treated as net operating losses (NOLs) arising in that year, and may be carried forward and back in accordance with the rules applicable to NOLs.

In general, NOL carryovers, like current-year losses other than passive losses, are allowed against any income of the taxpayer. In the case of individuals, estates and trusts, and personal service corporations, however, such nonpassive losses and NOLs are taken into account only after reducing income from passive activities by current and suspended deductions from passive activities (but not

below zero). Thus, the application of any prior-year suspended passive losses against current year passive income is taken into account before such NOLs are applied against net passive income. This permits the taxpayer to obtain the full benefit of suspended passive activity losses (which are limited in application) before using any losses that are not from passive activities (or NOL carryovers). If a taxpayer has net passive activity income for the year (after the application of all suspended passive losses), the income may be offset by current-year non-passive losses and by NOL carryovers.

In the case of a closely held corporation (other than a personal service corporation), the passive loss rule applies in modified form: passive losses may be used to offset active business income, but not portfolio income. In applying this rule, losses from passive activities (including such losses carried over from prior years after the effective date) are offset against income from passive activities to determine the aggregate passive loss, if any. If there is such a loss, it may be applied only against active business income, but not portfolio income, of the corporation. As is generally the case, NOLs are applied after the application of the passive loss rule.

The determination of whether a loss is suspended under the passive loss rule is made after the application of the at-risk rules and the interest deduction limitation, as well as other provisions relating to the measurement of taxable income. A loss that would not be allowed for the year because the taxpayer is not at risk with respect to it is suspended under the at-risk provision, not the passive loss rule. Similarly, if an interest deduction is disallowed under the interest deduction limitation, it is not disallowed again under the passive loss rule. Such amounts may become subject to the passive loss rule in subsequent years when they would be allowable under the at-risk or interest limitations.[9] During the 5-year period over which the passive loss rule is phased in, these rules interact in the same manner. In the first year after the effective date, for example, the investment interest limitation is applied and a portion of previously deductible investment interest is disallowed. That disallowed interest is not disallowed again under the passive loss rule, but only the remaining portion of interest (not disallowed due to the interest limitation phase-in) can be subject to disallowance under the phase-in of the passive loss rule.

Credits.—Credits arising with respect to passive activities generally are treated in the same manner as deductions.[10] That is, credits may not be used to offset tax attributable to income other than passive income. The amount of tax attributable to net passive income is determined by comparing (i) the amount that the taxpayer would pay with regard to all income, with (ii) the amount that

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[9] Amounts at risk are reduced even if deductions which would be allowed under the at-risk rules are suspended under the passive loss rule. Similarly, basis is reduced as under present law, even in the case where deductions are suspended under the passive loss rule. However, if an amount at risk or basis has been reduced by a deduction not allowed under the passive loss rule, the amount at risk or basis is not again reduced when the deduction becomes allowable under the passive loss rule.

[10] The allowability of foreign tax credits, however, is unaffected by the passive loss provision. Instead, foreign tax credits are limited solely by the various rules applying generally to such credits (e.g., the section 904 limitation, which is applied after determining the amounts of foreign source and worldwide income consistently with the application of the passive loss rule).

the taxpayer would pay with regard to taxable income other than net passive income (disregarding, in both cases, the effect of credits).

For example, if a taxpayer would owe $50,000 of tax disregarding net passive income, and $80,000 of tax considering both net passive and other taxable income (in both cases, disregarding the effect of credits), then the amount of tax attributable to passive income is $30,000. In this case, any credits not in excess of $30,000 attributable to the taxpayer's passive activities are allowable. Any passive activity credits not in excess of $30,000 are, in addition, subject to other limitations applicable to the allowance of credits. In the absence of net passive income for a taxable year, no tax is attributable to passive income, and passive credits generally are not allowable for the year.

Passive credits may be allowable to offset tax on income other than passive income with respect to the special rule providing up to $25,000 of benefit for certain rental real estate activities. Under this rule, credits are allowed to offset tax on the portion of the $25,000 (or less, as appropriate) that the taxpayer has not been able to offset by the use of deductions.

The amount of tax on such remaining portion (and thus, the amount of credits that can be used against other income, assuming that there are sufficient credits available) is determined by comparing (i) the amount that the taxpayer would owe (disregarding credits) with respect to income other than any net passive losses, but reduced by rental real estate deductions in the full amount allowable under the $25,000 rule, with (ii) the amount that the taxpayer would owe (again disregarding credits) if the allowable rental real estate deductions equalled $25,000 (or less as appropriate, i.e., in the phaseout range for this amount).

In general, credits arising with respect to passive activities, like deductions relating to such activities, can be carried forward indefinitely, and cannot be carried back. However, the character of a credit relating to a passive activity changes, in effect, when the credit becomes allowable under the passive loss rule (i.e., there either is sufficient passive income to allow its use, or it is within the scope of the $25,000 benefit for rental real estate activities). At such time, such credit is aggregated with credits relating to non-passive activities of the taxpayer, for purposes of determining whether all such credits are allowable in light of other limitations applying to the use of credits (e.g., the 75 percent tax liability limitation, and the provision that credits cannot be used to reduce regular tax liability to less than tentative minimum tax liability). In the event that any credits are not allowable because of such other limitations, the passive credits that are allowable under the passive activity rules are thereupon treated as non-passive credits arising in the current taxable year. The treatment of such credits then is determined in all respects by the general rules applying to such credits, including carryover periods.[11]

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[11] Credits that are subject to special limitations (e.g., the limitation on the use of research and development credits to offset certain unrelated income of the taxpayer) continue to be subject to such limitations when they cease to be limited by the passive activity rules.

Dispositions

In general.—When a taxpayer disposes of his entire interest in a passive activity, the actual economic gain or loss on his investment can be finally determined. Thus, under the passive loss rule, upon a fully taxable disposition, any overall loss from the activity realized by the taxpayer is recognized and allowed against income (whether active or passive income). This result is accomplished by triggering suspended losses upon disposition.

The reason for this rule is that, prior to a disposition of the taxpayer's interest, it is difficult to determine whether there has actually been gain or loss with respect to the activity. For example, allowable deductions may exceed actual economic costs, or may be exceeded by untaxed appreciation. Upon a taxable disposition, net appreciation or depreciation with respect to the activity can be finally ascertained. Since the purpose of the disposition rule is to allow real economic losses of the taxpayer to be deducted, credits, which are not related to the measurement of such loss, are not specially allowable by reason of a disposition.

Taxable dispositions of entire interest in activity.—The type of disposition that triggers full recognition of any loss from a passive activity is a fully taxable disposition of the taxpayer's entire interest in the activity. A fully taxable disposition generally includes a sale of the property to a third party at arm's length, and thus, presumably, for a price equal to its fair market value. Gain realized upon a transfer of an interest in a passive activity generally is treated as passive, and is first offset by the suspended losses from that activity. This accomplishes the purpose of the rule to recognize net income or loss with respect to the activity when it can be finally determined.

Where the taxpayer transfers an interest in a passive activity in a transaction in which the form of ownership merely changes, suspended losses generally are not allowed, because the gain or loss he has realized with respect to the activity has not been finally determined. (Such suspended losses are allowed, however, to the extent that any gain recognized on such a transfer, together with other income from passive activities for the year, exceeds losses from passive activities for the year.) Special rules are provided for gifts, death of the taxpayer, and other circumstances in which the taxpayer becomes no longer subject to the passive loss rule with respect to the activity.

The taxpayer must dispose of his entire interest in the activity in order to trigger the recognition of loss. If he disposes of less than his entire interest, then the issue of of ultimate economic gain or loss on his investment in the activity remains unresolved. A disposition of the taxpayer's entire interest involves a disposition of the taxpayer's interest in all entities that are engaged in the activity, and to the extent held in proprietorship form, of all assets used or created in the activity. If a general partnership or S corporation conducts two separate activities, fully taxable disposition by the entity of all the assets used or created in one activity constitutes a disposition of the partner's or shareholder's entire interest in the activity. Similarly, if a grantor trust conducts two separate activities, and sells all the assets used or created in one activity, the

grantor is considered as disposing of his entire interest in that activity. If the taxpayer has adequate records of the suspended losses that are allocable to that activity, and includes in income the gain (if any) allocable to his entire interest in the activity, such losses are allowed in full upon the disposition.

As an exception to the general rule, when a limited partnership that conducts two or more separate activities disposes of one of them, limited partners are not treated as having made a disposition triggering suspended losses. In order to accomplish a disposition that triggers suspended losses from limited partnership activities, the limited partner must dispose of his entire interest as a limited partner, and of all other interests that are treated as part of the same activity or activities as those of the limited partnership. Because a limited partner generally does not participate in any trade or business activity of the partnership, it is not appropriate to distinguish among activities of the partnership in determining whether he has made a disposition.

An installment sale of the taxpayer's entire interest in an activity in a fully taxable transaction triggers the allowance of suspended losses. The losses are allowed in each year of the installment obligation, in the ratio that the gain recognized in each year bears to the total gain on the sale.

A transfer of a taxpayer's interest in an activity by reason of his death causes suspended losses to be allowed to the extent they exceed the amount, if any, by which the basis of the interest in the activity is increased at death under section 1014. Suspended losses are eliminated to the extent of the amount of the basis increase. The losses allowed generally would be reported on the final return of the deceased taxpayer.

Other transfers

A gift of all or part of the taxpayer's interest in a passive activity does not trigger suspended losses. However, if he has given away his entire interest, he cannot make a future taxable disposition of it. Suspended losses are therefore added to the basis of the property (i.e., the interest in the activity) immediately before the gift. Similarly, if the taxpayer gives away less than all of his interest, an allocable portion of any suspended losses are added to the donee's basis.[12] Suspended losses of the donor are eliminated when added to the donee's basis, and the remainder of the losses continue to be suspended in the donor's hands. The treatment of subsequent deductions from the activity, to the extent of the donee's interest in it, depends on whether the activity is treated as passive in the donee's hands.

An exchange of the taxpayer's interest in an activity in a nonrecognition transaction, such as an exchange governed by sections 351, 721, or 1031 in which no gain or loss is recognized, does not trigger suspended losses. Following such an exchange, the taxpayer retains an interest in the activity, and hence has not realized the ultimate

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[12] For purposes of determining the donee's loss in a subsequent transaction, however, the donee's basis may not exceed the fair market value of the gift at the time we received it. *See*, sec. 1015(a). As under present law, losses attributable to unrealized depreciation in value of the property at the time of the gift are not deductible.

economic gain or loss on his investment in it. To the extent the taxpayer does recognize gain on the transaction (e.g., boot in an otherwise tax-free exchange), the gain is treated as passive activity income, against which passive losses may be deducted.

The suspended losses not allowed upon such a nonrecognition transaction continue to be treated as passive activity losses of the taxpayer, except that in some circumstances they may be applied against income from the property received in the tax-free exchange which is attributable to the original activity.[13] Such suspended losses may not be applied against income from the property which is attributable to a different activity from the one which the taxpayer exchanged.[14] Therefore, unless the taxpayer can show that income against which suspended losses are offset is clearly from the passive activity, his interest in which he exchanged for a different form of ownership, no such offset is permitted. For example, if a passive activity conducted by a general partnership is contributed to an S corporation, followed by the dissolution of the partnership, subsequent income from the activity may be offset by suspended losses from the activity of a shareholder who was formerly a passive general partner. When the taxpayer disposes of his entire interest in the property received in the tax-free exchange, then the remaining suspended losses, if any, are allowed in full.

Activity no longer treated as passive activity

Other circumstances may arise which do not constitute a disposition, but which terminate the application of the passive loss rule to the taxpayer generally, or to the taxpayer with respect to a particular activity. For example, an individual who previously was passive in relation to a trade or business activity which generates net losses may begin materially participating in the activity. When a taxpayer's participation in an activity is material in any year after a year (or years) during which he was not a material participant, previously suspended losses remain suspended and continue to be treated as passive activity losses. Such previously suspended losses, however, unlike passive activity losses generally, are allowed against income from the activity realized after it ceases to be a passive activity with respect to the taxpayer. As with tax-free exchanges of the taxpayer's entire interest in an activity, however, the taxpayer must be able to show that such income is from the same activity in which the taxpayer previously did not materially participate.[15]

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[13] This rule does not apply, however, to permit the offset of suspended passive losses against dividends or other income or gain otherwise treated as portfolio income. In addition, following some transactions such as a sec. 1031 like-kind exchange, for example, the taxpayer may no longer have an interest in the original activity. Therefore, there is no special rule permitting suspended losses from the prior interest to be offset by income from the new activity, unless it, too, is a passive activity.

[14] For example, suspended passive activity losses cannot be applied against portfolio income of a pass-through entity.

[15] The reason for this treatment is that the taxpayer could have deducted the suspended losses against income from the activity had the change in his relation to the activity not occurred. Although income from the activity may no longer be passive activity income, prior passive activity losses generated by *that activity* continue to be deductible against income from the activity. It would be inequitable to give less favorable treatment to a taxpayer whose income from an activity becomes active (i.e., not passive) than to one who continues to be merely a passive investor.

A similar situation arises when a corporation (such as a closely held corporation or personal service corporation) subject to the passive loss rule ceases to be subject to the passive loss rule because it ceases to meet the definition of an entity subject to the rule. For example, if a closely held corporation makes a public offering of its stock and thereafter ceases to meet the stock ownership criteria for being closely held, it is no longer subject to the passive loss rule. The corporation's ownership has been so broadened that the reason for limiting the corporation's ability to shelter its portfolio income becomes less compelling. A corporation which is not closely held is less susceptible to treatment as the alter ego of its shareholders, but competing considerations also apply. So as not to encourage tax-motivated transactions involving free transferability of losses, the suspended passive losses are not made more broadly applicable (i.e., against portfolio income) by the change in ownership, but continue to be applicable against all income other than portfolio income of the corporation. Deductions arising in years after the year in which the corporation's status changes are not subject to limitation under the passive loss rule.

3. Treatment of portfolio income

In general

Under the bill, portfolio income is not treated as income from a passive activity, and passive losses and credits generally may not be applied to offset it. Portfolio income generally includes interest, dividends, and royalties. Also included in portfolio income are gain or loss attributable to disposition of (1) property that is held for investment (and that is not a passive activity) and (2) property that normally produces interest, dividend, or royalty income.

Portfolio investments ordinarily give rise to positive income, and are not likely to generate losses which could be applied to shelter other income. Therefore, for purposes of the passive loss rule, portfolio income generally is not treated as derived from a passive activity, but rather is treated like other positive income sources such as salary. To permit portfolio income to be offset by passive losses or credits would create the inequitable result of restricting sheltering by individuals dependent for support on wages or active business income, while permitting sheltering by those whose income is derived from an investment portfolio.

Under the bill, dividends on C corporation stock, REIT and RIC dividends, interest on debt obligations, and royalties from the licensing of property generally are included in portfolio income. Similarly, gains (or losses) from the sale of interests which normally produce such income are treated as portfolio income or losses. These types of assets ordinarily are positive income sources. On the other hand, except as provided below, income from a general or limited partnership interest, from S corporation stock, from a grantor trust, or from a lease of property generally are not treated as portfolio income. Such interests can generate losses which may be applied to shelter unrelated income of the taxpayer. In addition, although such interests might otherwise be considered as held for investment, gains from the sale of such interests, when they are interests in passive activities, are not treated as portfolio income,

except to the extent gain on sale of such interests is itself attributable to portfolio income. For example, if a general partnership owns a portfolio of appreciated stocks and bonds and also conducts a business activity, a part of the gain on sale of a partnership interest would be attributable to portfolio income and would, consequently, be treated as portfolio income.

Portfolio income of a passive activity is taken into account separately from other items relating to the activity. Where a taxpayer has an interest in a passive activity, portfolio income of the activity generally is not taken into account in determining passive income or loss from the activity. Rather, such portfolio income is treated as non-passive income of the taxpayer. This rule is necessary in part because taxpayers otherwise would be able to shelter portfolio income to the extent that they transferred the assets from which it is derived to passive activities in which they had investment interests.

The application of the rule can be explained with regard to the example of a limited partnership that is engaged in the publication of a magazine. The partnership also holds a portfolio of dividend and interest bearing securities, but the income from them is more than offset by the tax losses of operating the magazine. Each limited partner must separately account for his share of the portfolio income and the losses from the operations of the magazine, and may not offset them against each other in calculating his tax liability. The portfolio income retains its character as income that is not income from a passive activity, despite the fact that non-portfolio income and loss attributable to a limited partnership interest is treated as income or loss from a passive activity.

The rule treating portfolio income as not from a passive activity does not apply to the extent that income, of a type generally regarded as portfolio income, is derived in the ordinary course of a trade or business. For example, the business income of a bank typically is largely interest. Similarly, a securities broker/dealer may earn a substantial portion of the income from the business in the form of dividends and gains on sales of dividend-bearing instruments. Interest income may also arise in the ordinary course of a trade or business with respect to installment sales and interest charges on accounts receivable.

In these cases, the rationale for treating portfolio-type income as not from the passive activity does not apply, since deriving such income is what the business activity actually, in whole or in part, involves. Accordingly, interest, dividend, or royalty income which is derived in the ordinary course of a trade or business is not treated, for purposes of the passive loss provision, as portfolio income. If a taxpayer directly, or through a passthrough entity, owns an interest in an activity deriving such income, such income is treated as part of the activity, which, as a whole, may or may not be treated as passive, depending on whether the taxpayer materially participates in the activity.

No exception is provided for the treatment of portfolio income arising from working capital, i.e., amounts set aside for the reasonable needs of the business. Although setting aside such amounts may be necessary to the trade or business, earning portfolio income with respect to such amounts is investment-related and not a part

of the trade or business itself. Under this rule, for example, interest earned on funds set aside by a limited partnership operating a shopping mall, for the purpose of expanding the mall, is treated as portfolio income and is not taken into account in determining a limited partner's passive income or loss from the activity of operating the shopping mall.

Under the bill, the Secretary may prescribe regulations under which items of income from a limited partnership or other passive activity are treated as portfolio income. The committee intends that such regulations will prevent taxpayers from structuring income-producing activities (including those that do not bear significant expenses) in ways that are designed to produce passive income that may be offset by unrelated passive losses. For example, such regulations may provide that, where necessary to prevent avoidance of the passive loss rule, a limited partner's share of income from a limited partnership is treated as portfolio income. Circumstances in which such treatment could be appropriate would include a transfer by a corporation of an income-producing activity to a limited partnership with a distribution to shareholders of limited partnership interests.

Treatment of closely held corporations

The passive loss rule applies to closely held C corporations (other than personal service corporations) in modified form. Such corporations may offset passive losses and credits against active business income, but not against portfolio income. Portfolio income of a closely held corporation generally has the same definition as portfolio income of any other taxpayer subject to the passive loss rule, except that, for purposes of such a corporation (as well as for a personal service corporation) the dividends received deduction is allowed.

4. Material participation

General rule

In general, a taxpayer's interest in a trade or business activity is not treated as an interest in a passive activity for a taxable year if the taxpayer materially participates in the activity throughout such year.[16] In certain instances, however, material participation is not determinative. Working interests in oil and gas properties generally are treated as active whether or not the taxpayer materially participates, and interests in rental activities are treated as passive whether or not the taxpayer materially participates. In the case of rental real estate activities, a separate standard, active participation, is relevant in determining whether the taxpayer is permitted to use losses and credits from such activities to offset up to $25,000 of other income.

Working as an employee, and providing services as part of a personal service business (including professional businesses such as law, accounting, and medicine), intrinsically require personal in-

[16] This rule is applied by considering services provided both by the taxpayer and by the taxpayer's spouse (whether or not such taxpayer and spouse file a joint return).

volvement by the taxpayer. Thus, by their nature, they generally are not passive activities.[17]

Material participation of a taxpayer in an activity is determined separately for each taxable year. In most cases, the material participation (or lack thereof) of a taxpayer in an activity is not expected to change from year to year, although there will be instances n which it does change.

Limited partnerships

In the case of a limited partnership interest, except to the extent provided by regulations, it is conclusively presumed that the taxpayer has not materially participated in the activity. In general, under relevant State laws, a limited partnership interest is characterized by limited liability, and in order to maintain limited liability status, a limited partner, as such, cannot be active in the partership's business. The presumption that a limited partnership interest is passive applies even when the taxpayer possesses the limited partnership interest indirectly through a tiered entity arrangement (e.g., the taxpayer owns a general partnership interest, or stock in an S corporation, and the partnership or corporation in which the taxpayer owns such interest itself owns a limited partnership interest in another entity).

When a taxpayer possesses both a limited partnership interest and another type of interest, such as a general partnership interest, with respect to an activity, lack of material participation is conclusively presumed with respect to the limited partnership interest (thus limiting the use of deductions and credits allocable thereto). The presence of material participation for purposes of any other interests in the activity owned by the taxpayer is determined with reference to the relevant facts and circumstances.

Under the bill, the Secretary of the Treasury is empowered to provide through regulations that limited partnership interests in certain circumstances will not be treated (other than through the application of the general facts and circumstances test regarding material participation) as interests in passive activities. It is intended that this grant of authority be used to prevent taxpayers from manipulating the rule that limited partnerships generally are passive, in attempting to evade the passive loss provision.[18]

For example, the exercise of such authority by the Secretary may be appropriate in certain situations where taxpayers divide their interests in activities between limited and general partnership interests, e.g., to facilitate establishing a disposition of the taxpayer's entire interest in an activity, or in connection with special allocations of items of income, deduction, or credit as between limited and general partnership interests. The exercise of such authority

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[17] The generally "active" nature of the above two undertakings is relevant, not only to the question of whether the taxpayer satisfies the material participation standard, but also to whether either of such two undertakings can be part of the same activity as any other undertaking. *See* section 5, *infra*.

[18] Examples of such evasion would include attempting to treat income that generally is regarded as not passive in nature (e.g., personal service income) as passive and accordingly as shelterable, or creating an unrealistically small separate "activity" in order to trigger suspended losses upon a partial disposition. Even absent the exercise of the Secretary's authority, items such as a guaranteed cash return or portfolio income from a limited partnership are not regarded as passive.

by the Secretary would also be appropriate if taxpayers were permitted under State law to establish limited liability entities (that are not taxable as corporations) for personal service or other active businesses, and to denominate as "limited partnership interests" any interests in such businesses related to the rendering of personal services. The exercise of such authority might also be appropriate where taxpayers sought to avoid limited partnership status with respect to substantially equivalent entities.

Involvement in operations on a regular, continuous, and substantial basis

Outside of the limited partnership context, the presence or absence of material participation generally is to be determined with reference to all of the relevant facts and circumstances. In order to be treated as materially participating for purposes of the provision, the taxpayer must be involved in the operations of the activity on a regular, continuous, and substantial basis. This standard is based on the material participation standards under Code sections 1402(a) (relating to the self-employment tax) and 2032A (relating to valuation of farm property for purposes of the estate tax). However, the standard is modified consistently with the purposes of the passive loss provision.

Thus, precedents regarding the application of those preexisting legal standards, whether set forth in regulations, rulings, or cases, are not intended to be controlling with regard to the passive loss rule. For example, whether or not, under existing authorities interpreting sections 1402(a) and 2032A, it could be argued that the material participation requirement (for purposes of those sections) is in certain circumstances satisfied by periodic consultation with respect to general management decisions, the standard under this provision is not satisfied thereby in the absence of regular, continuous, and substantial involvement in operations.

In order to satisfy the material participation standard, the individual's involvement must relate to operations. Consider, for example, the case of a general partnership engaged in the business of producing movies. Among the services that may be necessary to this business are the following: writing screenplays; reading and selecting screenplays; actively negotiating with agents who represent writers, actors, or directors; directing, editing, scoring, or acting in the films; actively negotiating with third parties regarding financing and distribution; and actively supervising production (e.g., selecting and negotiating for the purchase or use of sets, costumes, etcetera). An individual who does not make a significant contribution regarding these or similar services is not treated as materially participating. For example, merely approving a financing target, accepting a recommendation regarding selection of the screenplay, cast, locations, and director, or appointing others to perform the above functions, generally does not constitute involvement in operations.

In practice, a taxpayer is most likely to have materially participated in an activity for purposes of this provision in cases where involvement in the activity is the taxpayer's principal business. For example, an individual who spends thirty-five hours per week operating a grocery store, and who does not devote a comparable

amount of time to any other business, clearly is materially participating in the business of the grocery store.

By contrast, when an activity is not an individual's principal business, it is less likely that the individual is materially participating. For example, an individual who works full-time as an employee or in a professional service business (such as law, accounting, or medicine), and who has also invested in a general partnership or S corporation engaged in a business involving orange groves, is unlikely to have materially participated in the orange grove business.

However, the fact that an activity is or is not an individual's principal business is not conclusive in determining material participation. An individual may materially participate in no business activities (e.g., someone who does not work or is retired), or in more than one business activity (e.g., a farmer who lives and works on his farm and "moonlights" by operating a gas station).

Another factor that may be highly relevant in showing regular, continuous, and substantial involvement in the operations of an activity, and thereby establishing material participation, is whether, and how regularly, the taxpayer is present at the place or places where the principal operations of the activity are conducted. For example, in the case of an employee or professional who invests in a horse breeding activity, if the taxpayer lives hundreds of miles from the site of the activity, and does not often visit the site, such taxpayer is unlikely to have materially participated in the activity. By contrast, an individual who raises horses on land that includes, or is close to, his primary residence, is more likely to have materially participated.

Again, however, this factor is not conclusive. For example, even if the taxpayer in the above example lived near the site of the horse breeding activity, or visited it on numerous occasions during the year, it would still be necessary for the taxpayer to demonstrate regular, continuous, and substantial involvement in the operations of the activity. Such involvement might be shown, for example, by hiring and from time to time supervising those responsible for taking care of the horses on a daily basis, along with making decisions (i.e., not merely ratifying decisions) regarding the purchase, sale, and breeding of horses.

Moreover, under some circumstances, an individual may materially participate in an activity without being present at the activity's principal place of business. In order for such a taxpayer materially to participate, however, the taxpayer still must be regularly, continuously, and substantially involved in providing services integral to the activity. For example, in the case of an investor in a barge that transports grain along the Mississippi River, one way of materially participating is regularly to travel with the barge (not merely as a passenger, but performing substantial services with respect to the transporting of grain). Another way of materially participating, without being present at the principal place of business, is to work on a regular basis at finding new customers for the barge service, and to negotiate with customers regarding the terms on which the service is provided. In the case of farming, the committee anticipates that an individual who does not perform physical work relating to a farm, but who is treated as having self-em-

ployment income with respect to the farm under section 1402, generally will be treated as materially participating.

In determining material participation, the performance of management functions generally is treated no differently than rendering other services or performing physical work with respect to the activity. However, a merely formal and nominal participation in management, in the absence of a genuine exercise of independent discretion and judgment, does not constitute material participation.

For example, in the case of a cattle-feeding activity, the fact that an investor regularly receives and responds to "check-a-box" forms regarding when grain should be purchased, what the cattle should be fed, etcetera, may have little or no bearing on material participation. If the management decisions being made by the taxpayer are illusory (e.g., whether to feed the cattle or let them starve), or guided by an expert in the absence of any independent exercise of judgment by the taxpayer, or unimportant to the business,[19] they are given little weight.

The fact that a taxpayer has little or no knowledge or experience regarding the cattle-feeding business is highly significant in determining whether such taxpayer's participation in management is likely to amount to material participation. However, even if a taxpayer has such knowledge and experience, if he merely approves management decisions recommended by a paid advisor, the taxpayer's role is not substantial (and he accordingly has not materially participated), since the decisions could have been made without his involvement.

Even an intermittent role in management, while relevant, does not establish material participation in the absence of regular, continuous, and substantial involvement in operations. For example, the fact that one has responsibility for making significant management decisions with respect to an activity does not establish material participation, even if one from time to time exercises such responsibility. It is almost always true (disregarding special cases such as limited partnership interests) that the owner of an interest in an activity has some right to make management decisions regarding the activity, at least to the extent that his interest is not outweighed by that of other owners. Yet many individuals who possess significant ownership interests do not materially participate, and, under present law, have received tax benefits that the committee believes should be subject to limitation under the passive loss rule.[20] Participation in management cannot be relied upon

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[19] For example, management decisions may be unimportant to the business where the tax benefits from the business outweigh any risk of economic loss that may result from the decisions.

[20] Experience in applying existing legal standards confirms that a test based on participation in management is subject to manipulation and creates frequent factual disputes between taxpayers and the Internal Revenue Service. Section 464, for example, disallows prepaid expenses incurred in a farming activity if more than 35 percent of the loss from the activity is allocated to limited partners or persons who do not actively participate in management. As a result, farming activities that rely upon syndication to outside investors, and that are operated principally under the direction of an agent, have been structured so as to assist otherwise passive investors in demonstrating that they play a role in management decisions. While the Internal Revenue Service may argue in any such instance that an investor is not truly participating in management, such argument may be difficult to sustain in the absence of reliable direct evidence regarding the investor's independence of judgment. The committee expects that the material participation standard for purposes of the passive loss rule, in light of its focus on the taxpayer's role in actual operations, will not be similarly subject to manipulation and ambiguity.

unduly both because its genuineness and substantiality are difficult to verify, and because a general management role, absent more, may fall short of the level of involvement that the material participation standard in the provision is meant to require.

Providing legal, tax, or accounting services as an independent contractor (or as an employee thereof), or that the taxpayer commonly provides as an independent contractor, would not ordinarily constitute material participation in an activity other than the activity of providing these services to the public. Thus, for example, a member of a law firm who provides legal services to a client regarding a general partnership engaged in research and development, is not, if he invests in such partnership, treated as materially participating in the research and development activity by reason of such legal services.

The fact that a taxpayer utilizes employees or contract services to perform daily functions in running the business does not prevent such taxpayer from qualifying as materially participating. However, the activities of such agents are not attributed to the taxpayer, and the taxpayer must still personally perform sufficient services to establish material participation.

A special rule, derived from section 2032A, applies with respect to farming activities, permitting taxpayers to qualify as materially participating in certain situations involving retired or disabled individuals who previously were materially participating (as that term is used for purposes of the passive loss rule), or involving a surviving spouse of an individual who was so participating. Thus, to the extent that, under section 2032A(b)(4) or (5), such person would be treated as still materially participating during retirement or disability (or, in the case of a surviving spouse, after the decedent's death), such person shall be treated as materially participating for purposes of the passive loss provision.

Material participation by an entity subject to the passive loss rule

Special rules apply in the case of taxable entities that are subject to the passive loss rule. An estate or trust is treated as materially participating in an activity (or as actively participating in a rental real estate activity) if an executor or fiduciary, in his capacity as such, is so participating.[21] Portfolio income of an estate or trust must be accounted for separately, and may not be offset by losses from passive activities.

A corporation that is subject to the passive loss provision is treated as materially participating in an activity with respect to which one or more shareholders, owning in the aggregate more than 50 percent of the outstanding stock of the corporation, materially participate. Thus, for example, a corporation with 5 shareholders, each owning 20 percent of the stock, is treated as materially participating in an activity if three or more of such shareholders so participate. If one of the three shareholders who so participated owned only 5 percent of the stock, and as a result the three participating shareholders owned only 45 percent of the stock in the corporation,

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[21] In the case of a grantor trust, however, material participation is determined at the grantor rather than the entity level.

the corporation would not be treated as materially participating in the activity.

A corporation subject to the passive loss provision that is not a personal service corporation (as defined for purposes of the provision) may also be treated as materially participating in an activity if it meets the standard set forth in section 465(c)(7)(C), disregarding clause (iv). This standard generally is satisfied if (i) for the prior 12-month period, at least one full-time employee of the corporation provided sufficient services in active management with respect to the activity, (ii) during the same period, at least 3 full-time nonowner employees provided sufficient services directly related to the activity, and (iii) the amount of business deductions by the taxpayer attributable to the activity exceeded 15 percent of gross income from the business for the taxable year.

Active participation in a rental real estate activity

Allowance of $25,000 of losses and credits against other income under specified circumstances

For purposes of the passive loss provision, rental activities are treated as passive without regard to whether the taxpayer materially participates. The reasons for this rule are specified above in the section entitled "Reasons for Change."

In the case of rental real estate, however, some specifically targeted relief has been provided because rental real estate is held, in many instances, to provide financial security to individuals with moderate incomes. In some cases, for example, an individual may hold for rental a residence that he uses part-time, or that previously was and at some future time may be his primary residence. Even absent any such residential use of the property by the taxpayer, the committee believes that a rental real estate investment in which the taxpayer has significant responsibilities with respect to providing necessary services, and which serves significant nontax purposes of the taxpayer, is different in some respects from the activities that are meant to be fully subject to limitation under the passive loss provision.[22]

Under the relief provision for rental real estate, an individual may offset up to $25,000 of income that is not treated as passive, by using losses and credits from rental real estate activities with respect to which such individual actively participates.[23] (Low-income housing credits can be so used, as a part of the overall $25,000 amount, whether or not the individual actively participates in the rental real estate activity to which such credits relate.) This relief applies only if the individual does not have sufficient passive income for the year, after considering all other passive deductions

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[22] For example, in the case of a rental real estate investor whose cash expenses with respect to the investment (e.g., mortgage payments, condominium or management fees, and costs of upkeep) exceed cash inflows (i.e., rent), tax losses other than those relating to depreciation may not be providing any cash flow benefit.

[23] For purposes of applying this standard, as with respect to material participation, services performed both by the taxpayer and by the taxpayer's spouse are considered (whether or not such individuals file a joint return). It is worth noting that, while standards requiring active management or active participation in management apply for certain purposes under present law (see sections 55(e), 464(e)(2)(b), and 2032A), these standards are not the same as the active participation standard described herein.

and credits, to use fully the losses and credits from such rental real estate activities. No relief is provided under the provision to taxpayers other than individuals (i.e., C corporations subject to the passive loss provision).[24]

The $25,000 amount is reduced, but not below zero, by 50 percent of the amount by which the taxpayer's adjusted gross income for the year exceeds $100,000. In the case of a married individual not filing a joint return, no more than $12,500 of such relief is available, reduced by 50 percent of the amount by which such individual's adjusted gross income exceeds $50,000. For these purposes, adjusted gross income is determined without reference to net losses from passive activities (other than losses allowable solely by reason of a fully taxable disposition of an activity).

Since relief under this rule applies only to rental real estate activities, it does not apply to passive real estate activities that are not treated as rental activities under the provision (e.g., an interest in the activity of operating a hotel). Similarly, relief is not provided with regard to the renting of property other than real estate (e.g., equipment leasing).

Scope of active participation

A taxpayer is treated as not having actively participated in a rental real estate activity if the taxpayer (in conjunction with such taxpayer's spouse, even in the absence of a joint return) owns less than 10 percent (by value) of all interests in such activity.[25] This requirement is designed to assist in restricting the relief provided under the $25,000 rule (assuming all other applicable requirements are met) to appropriate circumstances — for example, the case of a home in which the taxpayer formerly lived or plans subsequently to live, as opposed to a syndicated real estate shelter. In addition, the 10 percent rule reflects the fact that active participation by a less than 10 percent owner typically represents services performed predominantly with regard to ownership interests of co-owners.

In the case of a taxpayer owning an interest in a rental real estate activity and meeting the 10-percent ownership requirement, up to $25,000 of relief may be available if the taxpayer actively participates in the activity. This standard is designed to be less stringent than the material participation requirement, in light of both the special nature of rental activities, which generally require less in the way of personal services, and the committee's reasons for providing up to $25,000 of relief in this instance.

The difference between active participation and material participation is that the former can be satisfied without regular, continuous, and substantial involvement in operations, so long as the taxpayer participates, e.g., in the making of management decisions or arranging for others to provide services (such as repairs), in a significant and *bona fide* sense. Management decisions that are rele-

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[24] Trusts and estates (other than grantor trusts, which are not separate taxable entities) are treated as individuals, and accordingly can qualify for relief (although a trust may cease to be treated as a trust for tax purposes if it is involved in a business activity; see *supra*). The active participation standard is applied with respect to executors or fiduciaries acting in their capacity as such.

[25] Since low-income housing credits are allowable without regard to active participation, they are unaffected by this requirement.

vant in this context include approving new tenants, deciding on rental terms, approving capital or repair expenditures, and other similar decisions.

Thus, for example, a taxpayer who owns and rents out an apartment that formerly was his primary residence, or that he uses as a part-time vacation home, may be treated as actively participating even if he hires a rental agent and others provide services such as repairs. So long as the taxpayer participates in the manner described above, a lack of participation in operations does not lead to the denial of relief.

A limited partner, to the extent of his limited partnership interest, is treated as not meeting the active participation standard.[26] In addition, a lessor under a net lease is unlikely to have the degree of involvement which active participation entails. Moreover, as with regard to the material participation standard, services provided by an agent are not attributed to the principal, and a merely formal and nominal participation in management, in the absence of a genuine exercise of independent discretion and judgment, is insufficient.

In this regard, it is useful to compare the above example of a taxpayer who owns and rents out an apartment that formerly was his primary residence with a tax shelter investor. The former taxpayer, even if he hires a rental agent and uses contract or other services to handle day-to-day problems such as routine repairs, still is likely to participate actively in light of the fact that he likely is not using it principally to generate tax losses.

By contrast, consider the case of a taxpayer who purchases an undivided interest in a shopping mall. The taxpayer purchased his interest from a promoter, based on a prospectus describing the investment opportunity and stressing the tax benefits of the $25,000 rule. Since one of the taxpayer's principal interests in the investment is to shelter income, he relies on a professional management company which also holds an interest in the shopping mall to make all significant management decisions. In order to create an evidentiary record purporting to show active participation, the management company sends letters to the investor detailing operating expenses, changes in tenants and new lease terms. The management company also informs the investor as to market trends, and requests approval of decisions to seek certain types of retailers as tenants. The investor ratifies such judgments without independently exercising judgment. The investor has not actively participated in the activity.

5. Definition of activity

In applying the passive loss rule, one of the most important determinations that must be made is the scope of a particular activity. This determination is important for several reasons. For example, if two undertakings are part of the same activity, the taxpayer

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[26] The delegation of regulatory authority to the Secretary to determine when a limited partnership interest should be treated as not passive does not specifically extend to providing relief under the active participation standard to limited partnership interests in rental real estate activities. The active participation rules do not prevent a limited partner from receiving $25,000 of benefit with regard to the low-income housing credit, since relief relating to such credit does not depend upon active participation.

need only establish material participation with respect to the activity as a whole, whereas if they are separate activities he must establish such participation separately for each. In the case of a disposition, knowing the scope of the activity is critical to determining whether the taxpayer has disposed of his entire interest in the activity, or only of a portion thereof.[27]

Defining separate activities either too narrowly or too broadly could lead to evasion of the passive loss rule. For example, an overly narrow definition would permit taxpayers to claim losses against salary, portfolio, or active business income by selectively disposing of portions of their interests in activities with respect to which there has been depreciation or loss of value, while retaining any portions with respect to which there has been appreciation. An overly broad definition would permit taxpayers to amalgamate undertakings that in fact are separate, and thus to use material participation in one undertaking as a basis for claiming without limitation losses and credits from another undertaking.

The determination of what constitutes a separate activity is intended to be made in a realistic economic sense. The question to be answered is what undertakings consist of an integrated and interrelated economic unit, conducted in coordination with or reliance upon each other, and constituting an appropriate unit for the measurement of gain or loss.

Under present law, section 183, relating to hobby losses, involves issues similar to those arising with respect to passive losses.[28] Section 183 requires that separate activities be identified in order to determine whether a specific activity constitutes a hobby. Treasury Regulations interpreting this provision note that all facts and circumstances of a specific case must be taken into account, and then identify as the most significant facts and circumstances: "the degree of organizational and economic interrelationship in various undertakings, the business purpose which is (or might be) served by carrying on the various undertakings separately or together . . . and the similarity of the various undertakings." These facts and circumstances likewise are relevant to determining the scope of an activity for purposes of the passive loss rule."[29]

In general, providing two or more substantially different products or services involves engaging in more than one activity (unless customarily or for business reasons provided together—e.g., the appliance and clothing sections of a department store). For example, operating a restaurant and engaging in research and development are objectively so different that they are extremely unlikely to be

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[27] Determining the scope of an activity also is important with respect to the 10 percent ownership requirement for actively participating in a rental real estate activity, and in certain situations where the taxpayer disposes of an activity other than through a taxable transaction.

[28] By contrast, the at-risk rules, to the extent that they define "activity," address issues different from those that are relevant with respect to passive losses. *See* section 465(c)(2). The at-risk rules define "activity" in terms of narrow asset units, such as individual items of property, in light of the goal of such rules to establish a relationship between each such asset and financing attributable to it. In the passive loss context, unlike the at-risk context, financing is not the relevant issue.

[29] *See* Treas. Reg. 1.183-1(d)(1). The provision in this regulation that a taxpayer's characterization of what constitutes an activity will be accepted unless it is unduly "artificial" does not apply with respect to the passive loss rule. While the committee anticipates that artificial characterizations will be disregarded as a matter of course with respect to passive losses, there is no presumption that the taxpayer's characterization is correct even absent such "artificiality."

part of the same activity. In addition, different stages in the production and sale of a particular product that are not carried on in an integrated fashion generally are not part of the same activity. For example, operating a retail gas station and engaging in oil and gas drilling generally are not part of the same activity. In general, normal commercial practices are highly probative in determining whether two or more undertakings are or may be parts of a single activity.

On the other hand, the fact that two undertakings involve providing the same products or services does not establish that they are part of the same activity absent the requisite degree of economic interrelationship or integration. For example, separate real estate rental projects built and managed in different locations by a real estate operator generally will constitute separate activities. Similarly, in the case of farming, each farm generally will constitute a separate activity. On the other hand, an integrated apartment project or shopping center generally will be treated as a single activity.

Separate research and development projects may constitute separate activities in the absence of a sufficient interrelationship between the activities (e.g., with regard to personnel, facilities used, or the common use of knowhow developed in specific undertakings). When sufficient interrelationship exists, however, the projects are part of the same activity. For example, if a particular research project is terminated, but knowhow developed from the project contributes to a subsequent project, it may be inaccurate to view the termination as establishing a loss. Any economic success realized by the second project may be attributable in part to amounts spent on the first project, and thus may establish that such amounts were not lost upon termination.

Certain types of integration among undertakings are not sufficient to establish that they are part of the same activity. For example, the fact that the taxpayer has ultimate management responsibilities with respect to different undertakings does not establish that they are part of the same activity, nor does the fact that the undertakings have access to common sources of financing, or benefit for goodwill purposes from sharing a common name. These common features may often be shared by all of the undertakings in which a particular individual is engaged, without establishing, in a substantial economic sense, that all such undertakings are part of the same activity.

The fact that two undertakings are conducted by the same entity (such as a partnership or S corporation) does not establish that they are part of the same activity. Conversely, the fact that two undertakings are conducted by different entities does not establish that they are different activities. Rather, the activity rules generally are applied by disregarding the scope of passthrough entities such as partnerships and S corporations.

With respect to limited partnerships, an additional rule applies in light of the special status of limited partnership interests with respect to material participation. For purposes of a disposition, it is conclusively presumed that a limited partnership interest includes no more than one activity. In addition, such an interest is not treated as being part of the same activity as any activity in which

the taxpayer is treated as materially participating. However, when otherwise appropriate, a limited partnership interest is treated as part of a larger activity in which the taxpayer does not materially participate (e.g., when two limited partnerships are conducting the same activity, or an individual is both a limited partner and a non-participating general partner with respect to the same activity).[30]

In applying the facts and circumstances test regarding what constitutes an activity, any undertaking that is accorded special treatment under the passive loss rule (e.g., treatment as always being active or as always being passive) is not treated as part of the same activity as any undertaking that does not receive identical treatment under the passive loss rule. For example, providing services as an employee or in a personal service business intrinsically is not passive, without requiring the examination of further facts and circumstances. Thus, such an undertaking generally is not part of the same activity as an undertaking in which further facts and circumstances must be examined. An oil and gas working interest is treated as not passive without regard to material participation, and thus is treated as separate from any undertaking not relating to oil and gas working interests.[31] This rule is necessary so that the special rules for particular undertakings will not in effect be extended to other types of undertakings (e.g., through the argument that an undertaking that is not a working interest is part of the same activity as a working interest, and hence should not be treated as passive even in the absence of material participation).

6. Rental activity

In general

Under the passive loss rule, a rental activity is generally treated as a passive activity regardless of whether the taxpayer materially participates in the activity. Deductions and credits from a rental activity generally may be applied to offset only other income from passive activities. In the case of rental real estate activities in which the taxpayer actively participates, a special rule permits the application of losses and credits from the activity against up to $25,000 of non-passive income of the taxpayer, for taxpayers other than corporations. A taxpayer is not considered to actively participate in the activity if he owns less than a 10 percent interest in it.

In determining what is a rental activity for purposes of these rules, prior law applicable in determining when an S corporation had passive rental income, as opposed to active business income, for purposes of continuing to qualify as an S corporation, provides a useful analogy.[32] The purpose of the prior law rule, like the pas-

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[30] These special rules regarding limited partnership interests do not apply in the case of any such interest that, pursuant to the Secretary's special regulatory authority, is treated as not intrinsically passive (i.e., as passive only to the extent established by examination of the relevant facts and circumstances).

[31] *See* section 6, *infra*, noting that, for the same reasons, a rental real estate undertaking, as well as a rental undertaking involving property other than real estate, each is treated as not part of the same activity as any other type of undertaking.

[32] Sec. 1372(e)(5) (as in effect prior to the Subchapter S Revision Act of 1982) is relevant in determining whether significant services are performed in connection with furnishing property. For example, regulations applicable in interpreting that section provided that rents did not in-

sive loss rule, is to distinguish between rental activity that is passive in nature and nonrental activity which may not be passive. Thus, under the passive loss rule, a rental activity generally is an activity, the income from which consists of payments principally for the use of tangible property, rather than for the performance of substantial services.[32a]

Some activities are not treated as rental activities under the passive loss rule even though they may involve the receipt of payments for the use of tangible property, because significant services are rendered in connection with such payments. Payments for the use of tangible property for short periods, with heavy turnover among the users of the property, may cause an activity not to be a rental activity, especially if significant services are performed in connection with each new user of the property. Another factor indicating that an activity should not be treated as a rental activity is that expenses of day-to-day operations are not insignificant in relation to rents produced by the property, or in relation to the amount of depreciation and the cost of carrying the rental property.

On the other hand, although the period for which property is rented is not in itself determinative of whether the activity is a rental activity, a long-term rental period (in comparison to the useful life of the property) and low turnover in the lessees of the property, is indicative that the activity is a rental activity.

For example, an activity consisting of the short-term leasing of motor vehicles, where the lessor furnishes services including maintenance of gas and oil, tire repair and changing, cleaning and polishing, oil changing and lubrication and engine and body repair, is not treated as a rental activity. By contrast, furnishing a boat under a bare boat charter, or a plane under a dry lease (i.e., without pilot, fuel or oil), constitutes a rental activity under the passive loss rule, because no significant services are performed in connection with providing the property.

Based on similar considerations, renting hotel rooms or similar space used primarily for lodging of transients where significant services are provided generally is not a rental activity under the passive loss rule. By contrast, renting apartments to tenants pursuant to leases (with, e.g., month-to-month or yearly lease terms) is treated as a rental activity.

Generally, being the lessor of property subject to a net lease is a rental activity. A net lease is defined for purposes of determining whether a leased property constitutes investment property, under the investment interest limitation, as a lease of property, if the section 162 deductions (other than rents and reimbursed amounts) are less than 15 percent of the rental income produced by the property, or if the lessor is either guaranteed a specified return or is guaran-

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clude payments for the use or occupancy of rooms where significant services were also rendered to the occupant (such as hotels and the like which furnish hotel services). The regulations further provided, "services are considered rendered to the occupant if they are primarily for his convenience and are other than those usually or customarily rentered in connection with the rental or rooms or other space for occupancy only. The supplying of maid service, for example, constitutes such services; whereas the furnishing of heat, light, ... the collection of trash, etc., are not considered as services rendered to the occupant.

[32a] A rental activity generally does not include payments for the use of intangible property (e.g., stocks), or other payments more properly characterized as interest (e.g., for the use of forbearance of money).

teed in whole or in part against loss of income. For purposes of the passive loss rule, it makes no difference how long the taxpayer has owned the leased property (see sec. 163(d(6)(B)).

Scope of rental activity

Some businesses involve the conduct of rental activities in association with other activities not involving renting tangible property. Although the other activities may immediately precede the rental activity, be conducted by the same persons, or take place in the same general location, they are not treated as a part of the rental activity, because under the passive loss rule rental activities are considered passive activities without regard to the taxpayer's material participation. In the case of other activities, an examination of the taxpayer's material participation generally determines whether an activity is passive. Rental activities generally are treated as separate from nonrental activities involving the same persons or property. Thus, for example, automobile leasing is treated as a different activity from automobile manufacturing, and real estate construction and development is a different activity from renting the newly constructed building.

Similarly, suppose a travel agency operated in the form of a general partnership has its offices on three floors of a ten-story building that it owns. The remainder of the space in the building is rented out to tenants. The travel agency expects to take over another floor for its own use in a year. The partnership is treated as being engaged in two separate activities: a travel agency activity and a rental real estate activity. Deductions and credits attributable to the building are allocable to the travel agency activity only to the extent that they relate to the space occupied by the travel agency during the taxable year.

Separate rental real estate activity

Because only rental real estate activities are eligible for the $25,000 offset of losses and credits against non-passive income, a rental real estate undertaking is not considered as part of the same activity as any undertaking other than another rental real estate undertaking. For these purposes, the word "rental" is interpreted consistently with its meaning in other respects for purposes of the passive loss provision. Thus, for example, a hotel is treated neither as a rental real estate undertaking, nor as consisting of two activities only one of which is a rental real estate undertaking.

To be eligible for the $25,000 offset, a taxpayer must actively participate in the rental real estate activity. He is not considered to actively participate unless he has at least a 10 percent interest in the activity, because without a significant ownership interest his participation in the activity is likely to be for the benefit of other owners. For purposes of determining whether his interest in the activity amounts to at least 10 percent, separate buildings are treated as separate rental real estate activities if the degree of integration of the business and other relevant factors do not require treating them as parts of a larger activity (e.g., an integrated shopping center).

In the case of units smaller than an entire building, it similarly is necessary to assess the degree of business and functional integra-

tion among the units in determining whether they are separate activities. A cooperative apartment in an apartment building, owned by a taxpayer unrelated to those owning the other apartments in the building, generally will qualify as a separate activity, despite the fact that ownership of the building may be shared with owners of other apartments in the building, and despite the sharing with other apartments of such services as management and maintenance of common areas. By contrast, ownership of an undivided interest in a building, or of an area too small to be rented as a separate unit (or that is not rented as a separate unit) does not qualify as a separate activity.

In the case of a commercial building, for example, that is rented out to various tenants, and in which different parties own different floors, it again is necessary to examine the degree of integration with which business relating to different floors is conducted. An arrangement in which the rights to the various floors are separately sold to different parties, but rental of the building is handled in a centralized fashion, generally constitutes a single activity, whereas such treatment might not be appropriate if the owners of different floors separately manage their own rental businesses.

7. Working interest in oil and gas property

When a taxpayer owns a working interest in an oil and gas property, the working interest is not treated as a passive activity, whether or not the taxpayer materially participates. Thus, losses and credits derived from such activity can be used to offset other income of the taxpayer without limitation under the passive loss rule.

In general, a working interest is an interest with respect to an oil and gas property that is burdened with the cost of development and operation of the property.[33] Rights to overriding royalties, production payments, and the like, do not constitute working interests, because they are not burdened with the responsibility to share expenses of drilling, completing, or operating oil and gas property. Similarly, contract rights to extract or share in oil and gas, or in profits from extraction, without liability to share in the costs of production, do not constitute working interests. Income from such interests generally is considered to be portfolio income.

A working interest generally has characteristics such as responsibility for signing authorizations for expenditures with respect to the activity, receiving periodic drilling and completion reports, receiving periodic reports regarding the amount of oil extracted, possession of voting rights proportionate to the percentage of the working interest possessed by the taxpayer, the right to continue activities if the present operator decides to discontinue operations, a proportionate share of tort liability with respect to the property (e.g., if a well catches fire), and some responsibility to share in further costs with respect to the property in the event that a decision is made to spend more than amounts already contributed.

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[33] *See* Treas. Reg. sec. 1.612-4(a), along with cases and rulings decided thereunder, such as *Phillips* v. *Comm'r* 233 F. Supp. 59 (E.D. Tex. 1964), aff'd. *per curiam*, (5th Cir.), 66-1 U.S.T.C. Paragraph 9157; *Haass* v. *Comm'r*, 55 T.C. 43 (1970), *acq.*, 1971-2 C.B. 2; *Cottingham* v. *Comm'r*, 63 T.C. 695 (1975); *Miller* v. *Comm'r* 78-1 U.S.T.C. Paragraph 9127 (C.D. Cal. 1977); Rev. Rul. 68-139, 1968-1 C.B. 311.

However, the fact that a taxpayer is entitled to decline, or does decline, to make additional contributions under a buyout, nonparticipation, or similar arrangement, does not contradict such taxpayer's possessing a working interest. In addition, the fact that tort liability may be insured against does not contradict such taxpayer's possessing a working interest.

When the taxpayer's form of ownership limits the liability of the taxpayer, the interest possessed by such taxpayer is not a working interest for purposes of the passive loss provision. Thus, an interest owned by a limited partnership interest is not treated as a working interest with regard to any limited partner, and an interest owned by an S corporation is not treated as a working interest with regard to any shareholder. The same result follows with respect to any form of ownership that is substantially equivalent in its effect on liability to a limited partnership interest or interest in an S corporation, even if different in form. The rule is applied by looking through tiered entities. For example, a general partner in a partnership that owns a limited partnership interest in a partnership that owns a working interest is not treated as owning a working interest.

A special rule applies in any case where, for a prior taxable year, net losses from a working interest in a property were treated by the taxpayer as not from a passive activity. In such a case, any net income realized by the taxpayer from the property (or from any substituted basis property, e.g., property acquired in a section 1031 like-kind exchange for such property) in a subsequent year also is treated as active. Under this rule, for example, if a taxpayer claims losses for a year with regard to a working interest and then, after the property to which the interest relates begins to generate net income, transfers the interest to an S corporation in which he is a shareholder, or to a partnership in which he has an interest as a limited partner, his interest with regard to the property continues to be treated as not passive.[34]

Under some circumstances, deductions relating to a working interest may be subject to limitation under other provisions in the Internal Revenue Code. For example, protection against loss through nonrecourse financing, guarantees, stop-loss agreements or other similar arrangements, may cause certain deductions allocable to the taxpayer to be disallowed under section 465. Such limitations are applied prior to and independently of the passive loss rule.

Effective Date

The passive loss rule is effective in taxable years beginning on or after January 1, 1987. It applies to all passive activity losses incurred in taxable years beginning on or after that date, and to passive activity credits for property placed in service in taxable years beginning on or after that date. However, the rule is phased in over a 5-year period. The amount disallowed under the passive loss provision during any year in the transitional period cannot exceed

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[34] This rule applies whether or not the working interest would have been treated as passive in the absence of the provision treating working interests as *per se* active, i.e., if material participation were relevant in this context.

the applicable percentage of the amount that would be disallowed for that year under the provision if fully effective. The applicable percentage is 35 percent for 1987, 60 percent for 1988, 80 percent for 1989, 90 percent for 1990, and 100 percent for 1991 and thereafter.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $823 million in 1987, $2,945 million in 1988, $3,822 million in 1989, $5,027 million in 1990, and $6,028 million in 1991.

B. Extension of At-Risk Rules to Real Estate Activities (sec. 1411 of the bill and sec. 465 of the Code)

Present Law

Loss limitation rules

Present law (Code sec. 465) provides an at-risk limitation on losses from business and income-producing activities other than real estate and certain corporate active business activities, applicable to individuals and to certain closely held corporations.[1] The rule is designed to prevent a taxpayer from deducting losses in excess of the taxpayer's actual economic investment in an activity.

Under the loss limitation at-risk rules, a taxpayer's deductible losses from an activity for any taxable year are limited to the amount the taxpayer has placed at risk (i.e., the amount the taxpayer could actually lose) in the activity. The initial amount at risk is generally the sum of (1) the taxpayer's cash contributions to the activity; (2) the adjusted basis of other property contributed to the activity; and (3) amounts borrowed for use in the activity with respect to which the taxpayer has personal liability or has pledged as security for repayment property not used in the activity. This amount is generally increased each year by the taxpayer's share of income and is decreased by the taxpayer's share of losses and withdrawals from the activity.

A taxpayer is generally not considered at risk with respect to borrowed amounts if (1) the taxpayer is not personally liable for repayment of the debt (nonrecourse loans); or (2) the lender has an interest (other than as a creditor) in the activity (except to the extent provided in Treasury regulations). The taxpayer is also not considered at risk with respect to amounts for which the taxpayer is protected against loss by guarantees, stop-loss arrangements, insurance (other than casualty insurance) or similar arrangements. Losses which may not be deducted for any taxable year because of the loss limitation at-risk rule may be deducted in the first succeeding year in which the rule does not prevent the deduction.

The loss limitation at-risk rule is applicable to individuals and to closely held corporations more than 50 percent in value of the stock in which was owned, at any time during the last half of the taxable year, by or for 5 or fewer individuals. Stock ownership is generally determined according to the rules applicable for purposes of identifying a personal holding company (sec. 542(a)(2)). In the

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[1] The Tax Reform Act of 1976 (P.L. 94-455) applied the at-risk rule to four specific activities: (1) holding, producing, or distributing motion picture films or video tapes; (2) farming; (3) leasing of personal property; and (4) exploring for, or exploiting, oil and natural gas resources. The Revenue Act of 1978 (P.L. 95-600) extended the rule to all activities except real estate and certain equipment leasing engaged in by closely held corporations. The Deficit Reduction Act of 1984 (P.L. 98-369) created an exception for certain active businesses of closely held C corporations.

case of a partnership or S corporation, the rules apply at the partner or shareholder level respectively.

Generally, a taxpayer's amount at risk is separately determined with respect to separate activities. Nevertheless, activities are treated as one activity (i.e., aggregated) if the activities constitute a trade or business and (1) the taxpayer actively participates in the management of that trade or business, or (2) in the case of a trade or business carried on by a partnership or S corporation, 65 percent or more of losses is allocable to persons who actively participate in the management of the trade or business. The Treasury has authority to prescribe regulations under which activities are aggregated or treated as separate activities.[2] In addition, an exception from the at-risk rules is provided for certain active business activities of closely held corporations, and for this purpose, the component members of an affiliated group are treated as a single taxpayer (sec. 465(c)(7)(F)).

Investment tax credit rules

Present law also provides rules requiring the taxpayer to be at-risk with respect to property in order to qualify for the investment tax credit (sec. 46(c)(8)). These rules provide an exception where the property is financed by certain third party nonrecourse loans.

Reasons for Change

The committee believes it is appropriate to apply the at-risk rules to real estate activities so as to limit the opportunity for overvaluation of property (resulting in inflated deductions), and to prevent the transfer of tax benefits arising from real estate activities to taxpayers with little or no real equity in the property.

The bill therefore extends the present law at-risk rules to real estate, with an exception for certain nonrecourse financing provided by organizations in the business of lending.

Nonrecourse financing by the seller of real property (or a person related to the seller) is not treated as an amount at risk under the bill, because there may be little or no incentive to limit the amount of such financing to the value of the property. In the case of commercial financing secured solely by the real property, however, the lender is much less likely to make loans which exceed the property's value or which cannot be serviced by the property; it is more likely that such financing will be repaid and that the purchaser consequently has or will have real equity in the activity.

The committee is aware of the practice of institutional real estate joint ventures to borrow from a commercial lender who may also have a substantial equity interest in the venture. Where the lender is not the seller or related to the seller, the committee believes that the opportunities for overvaluation may be limited to the same degree as if the lender were an unrelated third party. In the case of legitimate business ventures, the committee believes that it is appropriate to permit the financing provided by such a lender to be treated as an amount at risk.

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[2] Similar rules apply in the case of activities described in section 465(c)(2)(A) (which includes certain motion picture, farming, leasing, oil and gas and geothermal deposit activities).

Explanation of Provision

Under the bill, the present law at-risk rules are extended to the activity of holding real property. In the case of such an activity, the bill provides an exception for qualified nonrecourse financing which is secured by real property used in the activity; the taxpayer is treated at-risk with respect to such financing.

Qualified nonrecourse financing

The exception provided for qualified nonrecourse financing is similar to the rules for qualified commercial financing under the investment tax credit at-risk rules of present law, with certain modifications. Qualified nonrecourse financing generally includes financing that is secured by real property used in the activity and that is loaned by a Federal, State or local government or instrumentality thereof or guaranteed by Federal, State, or local government, or borrowed by the taxpayer from a qualified person, with respect to the activity of holding real property (other than mineral property). Convertible debt is not treated as qualified nonrecourse financing. The holding of real property includes the holding of personal property and the providing of services which are incidental to the use of the real property.

For this purpose, nonrecourse financing means financing with respect to which no person is personally liable, except to the extent otherwise provided in regulations. Regulations may set forth the circumstances in which guarantees, indemnities, or personal liability (or the like) of a person other than the taxpayer will not cause the financing to be treated as other than qualified nonrecourse financing.

Qualified persons include any person actively and regularly engaged in the business of lending money. Such persons generally would include, for example, a bank, savings and loan association, credit union, or insurance company regulated under Federal, State, or local law, or a pension trust. However, qualified persons do not include (1) any person from which the taxpayer acquired the property (or a person related to such person); or (2) any person who receives a fee (e.g., a promoter) with respect to the taxpayer's investment in the property (or a person related to such person). Thus, for example, seller financing and promoter financing are not qualified nonrecourse financing.

Under this rule, real estate joint ventures may obtain financing from an otherwise qualified lender who has an equity interest in the venture,[28] provided the lender is not the seller or related to the seller. Seller financing, of course, cannot qualify under this rule. The rule is not intended to facilitate the transfer of tax benefits or the overvaluation of property (and inflation of deductions). In addition, as is generally the case under the at risk rules, the financing must actually be debt and not disguised equity.

The bill adopts the definition of related person applicable under the investment tax credit at-risk rules. Under this rule, related

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[28] The committee intends that the Treasury Department examine sections 704 and 752 in light of the exception from the at risk rules for nonrecourse loans made by qualified institutional lenders that are also partners (or related to partners), and in light of changes made by the Deficit Reduction Act of 1984.

persons generally include family members, fiduciaries, and corporations or partnerships in which a person has at least a 10-percent interest.

A special rule for partnerships provides that partnership-level qualified nonrecourse financing may increase a partner's (including a limited partner's) amount at risk, determined in accordance with his share of the liability (within the meaning of section 752), provided the financing is qualified nonrecourse financing with respect to that partner as well as with respect to the partnership. For the purpose of determining whether partnership borrowings are treated as qualified nonrecourse financing with respect to the partnership, the partnership is treated as the taxpayer. For the purpose of determining whether a share of partnership borrowings is treated as qualified nonrecourse financing with respect to a partner, the partner is also treated as the borrower. The amount for which partners are treated as at risk under this rule may not exceed the total amount of the qualified nonrecourse financing at the partnership level.

In the case of property taken subject to a nonrecourse debt which constituted qualified nonrecourse financing in the hands of the original borrower, such debt may be considered as qualified nonrecourse financing as to the original borrower's transferee, provided that all the criteria for qualified nonrecourse financing are satisfied for that debt with respect to the transferee. The same rule applies to subsequent transfers of the property taken subject to the debt, and to the admission of new partners to a partnership (or sale or exchange of a partnership interest), so long as the debt constitutes qualified nonrecourse financing with respect to each transferee or new partner.

Aggregation rules

The present law at-risk aggregation rules (sec. 465(c)(3)(B)) generally apply to the activity of holding real property. Under these rules, it is intended that if a taxpayer actively participates in the management of several partnerships each engaged in the real estate business, the real estate activities of the various partnerships may be aggregated and treated as one activity with respect to that partner for purposes of the at-risk rules. Also it is intended that the regulations relating to the treatment of at-risk amounts in the case of an affiliated group of corporations (Treasury reg. sec. 1.1502-45) be appropriately modified, in the case of an affiliated group which is engaged principally in the real estate business, to allow aggregation of the real estate activities, where the component members of the group are actively engaged in the management of the real estate business (not including real estate financing other than between members of the affiliated group).

Effective Date

The provision applies to losses attributable to property acquired after December 31, 1986. In the case of a partnership or S corporation, property acquired means property owned by the partnership or S corporation and also an interest in the partnership or stock in the S corporation. A transition rule provides that this amendment

to the at-risk rules does not apply to the sale of a multi-use athletic stadium in Pittsburgh for which a letter of understanding was entered into before April 16, 1986.

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by $13 million in 1987 and $4 million in 1988, and increase fiscal year budget receipts by $18 million in 1989, $14 million in 1990, and $20 million in 1991.

C. Tax Credit for Rehabilitation Expenditures (sec. 1412 of the bill and secs. 46(b), 48(g), and 48(q) of the Code)

Present Law

A three-tier investment tax credit is provided for qualified rehabilitation expenditures. The credit is 15 percent for nonresidential buildings at least 30 years old, 20 percent for nonresidential buildings at least 40 years old, and 25 percent for certified historic structures (including residential buildings). A certified historic structure is defined as a building (and its structural components) that is listed in the National Register of Historic Places, or is located in a registered historic district and certified by the Secretary of the Interior as being of historic significance to the district.

The rehabilitation credit is available only if the taxpayer elects to use the straight-line method of cost recovery with respect to the rehabilitation expenditures. If the 15- or 20-percent investment credit is allowed for qualified rehabilitation expenditures, the basis of the property is reduced by the amount of credit earned (and the reduced basis is used to compute cost recovery deductions) (sec. 48(q)(1) and (3)). The basis is reduced by 50 percent of the 25-percent credit allowed for the rehabilitation of certified historic structures.

Qualified rehabilitation expenditures are eligible for the credit only if incurred in connection with a substantial rehabilitation that satisfies an external-walls requirement. The test of substantial rehabilitation generally is met if the qualified expenditures during a 24-month measuring period exceed the greater of the adjusted basis of the building as of the first day of the 24-month period, or $5,000. (In phased rehabilitations, the 24-month measuring period is extended to 60 months.)

The external-walls requirement provides generally that at least 75 percent of the existing external walls of the building must be retained in place as external walls in the rehabilitation process. An alternative test provides that the external-walls requirement is met if (1) at least 75 percent of the external walls are retained in place as either internal or external walls, (2) at least 50 percent of such walls are retained in place as external walls, and (3) at least 75 percent of the building's internal structural framework is retained in place.

In the case of rehabilitations of certified historic structures, certain additional rules apply. In particular, the Secretary of the Interior must certify that the rehabilitation is consistent with the historic character of the building or the historic district in which the building is located. In fulfilling this statutory mandate, the Secretary of the Interior's Standards for Rehabilitation are applied. See 36 CFR Part 67.7 (March 12, 1984).

Qualified rehabilitation expenditures generally include any amounts properly chargeable to capital account of a building in connection with a rehabilitation, but do not include the following:

(1) the cost of acquiring a building or an interest in a building (such as a leasehold interest);

(2) the cost of facilities related to a building (such as a parking lot); and

(3) the cost of enlarging an existing building.

Lessees are entitled to the credit for qualified expenditures incurred by the lessee if, on the date the rehabilitation is completed, the remaining lease term (without regard to renewal periods) is at least as long as the applicable recovery period (generally 19 years; 15 years in the case of low-income housing). Under regulations prescribed by the Secretary of the Treasury, the substantial rehabilitation test for a lessee is generally applied by comparing the lessee's qualified rehabilitation expenditures to the lessor's adjusted basis in the building (i.e., the lessee steps into the shoes of the lessor).

The rehabilitation credit is subject to recapture if the rehabilitated building is disposed of or otherwise ceases to be qualified investment credit property with respect to the taxpayer during the five years following the date the property is placed in service. If the Department of the Interior decertifies a rehabilitation of a certified historic structure during the recapture period, the property ceases to be qualified investment credit property.

Reasons for Change

In 1981, Congress restructured and increased the tax credit for rehabilitation expenditures. Congress was concerned that the tax incentives provided to investments in new structures (e.g., accelerated cost recovery) would have the undesirable effect of reducing the relative attractiveness of the prior-law incentives to rehabilitate and modernize older structures, and might lead investors to neglect older structures and relocate their businesses.

The committee has concluded that the incentives granted to rehabilitations in 1981 remain justified. The committee believes that such incentives are needed because the social and aesthetic values of rehabilitating and preserving older structures are not necessarily taken into account in investors' profit projections. Additionally, a tax incentive is needed because market forces might otherwise channel investments away from such projects because of the extra costs of undertaking rehabilitations of older or historic buildings.

The committee also sought to focus the credit particularly on historic and certain older buildings and to ensure that the credits accomplish their intended objectives of preserving such historic and older buildings. In addition, the committee was concerned that the existing credit percentages would be too high in the context of the lower overall rates provided in the bill. For example, the 25-percent credit in present law offsets 50 cents of income for every $1 of rehabilitation expenditures made by a taxpayer in the top 50-percent bracket. A credit of 13.5 percent would accomplish the same offset to income with a top bracket of 27 percent. Similarly reduced credits would reproduce the same offsets to income as the current 15-percent and 20-percent rehabilitation credits.

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Explanation of Provision

Two-tier credit

The committee bill replaces the existing three-tier rehabilitation credit with a two-tier credit for qualified rehabilitation expenditures. The credit percentage is 20 percent for rehabilitations of certified historic structures and 10 percent for rehabilitations of buildings (other than certified historic structures) originally placed in service before 1936.

Retention of certain rules

As under present law, the 10-percent credit for the rehabilitation of buildings that are not certified historic structures is limited to nonresidential buildings, but the 20-percent credit for rehabilitation of historic buildings is available for both residential and nonresidential buildings.

The present law provisions that determine whether rehabilitation expenditures qualify for the credit were generally retained in the bill. In general, no changes were made regarding the substantial rehabilitation test, the specific types of expenditures that do not qualify for the credit, the provisions applicable to certified historic structures and tax-exempt use property, or the recapture rules. No expenditure would be eligible for credit unless the taxpayer elects to recover the costs of the rehabilitation using the straight-line method of depreciation. Further, expenditures incurred by a lessee would not qualify for the credit unless the remaining lease term, on the date the rehabilitation is completed, is at least as long as the recovery period under ACRS (generally either 27.5 for residential real property or 31.5 for nonresidential real property).

External-walls requirement

The external-walls requirement was significantly modified by the bill. The existing provision that requires 75 percent of the existing external walls to be retained in place as external walls was deleted and replaced by the alternative test provided in present law that requires the retention in place of (1) at least 75 percent of the existing external walls (including at least 50 percent as external walls) as well as (2) at least 75 percent of the building's internal structural framework. Thus, unlike the situation that can occur under present law, a building that is completely gutted cannot qualify for the rehabilitation credit under the committee bill. In general, a building's internal structural framework includes all load-bearing internal walls and any other internal structural supports, including the columns, girders, beams, trusses, spandrels, and all other members that are essential to the stability of the building.

Because the committee believes that the Secretary of the Interior's Standards for Rehabilitation ensure that certified historic structures are properly rehabilitated, the external-walls requirement for such buildings was deleted by the bill in order to provide the Secretary of the Interior with appropriate flexibilty. The committee intends, however, that rehabilitations eligible for the 20-percent credit should continue to be true rehabilitations and not substantially new construction. The committee expects, therefore, that

the Secretary of the Interior will continue generally to deny certification to rehabilitations during which less than 75 percent of the external walls are not retained in place.

Basis reduction

The bill deletes the limited exception in current law that requires a basis reduction for only 50 percent of the credit in the case of certified historic structures. Thus, a full basis adjustment is required for both the ten-percent and 20-percent rehabilitation credits.

Effective Date

The modifications to the rehabilitation credit are generally applicable to property placed in service after December 31, 1986.

A general transitional rule provides that the modifications to the rehabilitation credit (other than certain reductions in the credit percentage—see below) will not apply to property placed in service before January 1, 1994, if the property is placed in service (as rehabilitation property) as part of either a rehabilitation completed pursuant to a written contract that was binding (under applicable state law) on March 1, 1986. This rule also applies to a rehabilitation with respect to property (including any leasehold interest) that was acquired before March 2, 1986, or was acquired on or after such date pursuant to a written contract that was binding on March 1, 1986, if (1) the rehabilitation was completed pursuant to a written contract that was binding on March 1, 1986, parts 1 (if necessary) and 2 of the Historic Preservation Certification Application were filed with the Department of the Interior (or its designee) before March 2, 1986, or (2) the lesser of $1,000,000 or five percent of the cost of the rehabilitation (including only qualified rehabilitation expenditures) was incurred before March 2, 1986, or is required to be incurred pursuant to a written contract that was binding on March 1, 1986. Additional transitional rules are provided for specific projects.

If a taxpayer transfers his rights in property under rehabilitation or under a binding contract to another taxpayer, the modifications do not apply to the property in the hands of the transferee, as long as the property was not placed in service before the transfer by the transferor. For purposes of this rule, if by reason of sales or exchanges of interests in a partnership, there is a deemed termination and reconstitution of a partnership under section 708(b)(1(B), the partnership is to be treated as having transferred its rights in the property under rehabilitation or the binding contract to the new partnership.

If property that qualifies under any of the foregoing transitional rules is placed in service after December 31, 1986, except in the case of certain projects, the applicable credit percentages are reduced from 25, 20, and 15 to 20, 13, and ten, respectively, and a full basis adjustment is required.

Property that qualifies for transitional relief under one of the rules described above is also excepted from the depreciation changes made by section 201 of the bill.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $44 million in 1987, $167 million in 1988, $612 million in 1989, $1,429 million in 1990, and $1,797 million in 1991.

D. Low-Income Housing Credit (sec. 1413 of the bill and new sec. 42 of the Code)

Present Law

No low-income housing tax credit is provided under present law, but several other provisions relating to low- and moderate-income rental housing are available.

Tax-exempt bond financing

Tax-exempt bonds may be used to finance multifamily residential rental property if at least 20 percent (15 percent in targeted areas) of the housing units are occupied by individuals whose income does not exceed 80 percent of the area median income when they first occupy the unit. Multifamily rental housing bonds are exempt from volume caps and certain other requirements applicable to other IDBs. Title XV of the bill makes several changes in the rules applicable to these tax-exempt bonds.

Depreciation

Certain low-income rental housing may be depreciated over 15 years using the 200-percent declining balance method; all other residential real property is limited to a 19-year recovery period and the 175-percent declining balance method. Title II of the bill amends this rule to provide a 27½ year recovery period using the straight-line method for all residential rental property.

5-year amortization of rehabilitation expenditures

Taxpayers may elect to amortize over a 60-month period certain qualifying expenditures for additions or improvements to low-income rental housing having a useful life of at least five years. Expenditures with respect to any dwelling unit generally are not eligible to the extent that they aggregate more than $20,000 (in certain cases, $40,000).

The election is scheduled to expire for expenditures incurred after December 31, 1986 (except in cases where rehabilitation began, or a binding contract for such expenditures was entered into, before January 1, 1987).

Construction period interest and taxes

Generally, interest paid or accrued on indebtedness incurred with respect to real property and real property taxes attributable to the construction period for such property must be capitalized and amortized over a ten-year period. Interest and taxes related to certain low-income rental housing are not subject to this capitalization requirement. As part of the changes in coordination with providing a new tax credit for low-income housing, Title III of the bill repeals the exception for low-income rental housing.

Reasons for Change

The committee is concerned that the existing tax preferences for low-income rental housing have not been effective in providing affordable housing for low-income individuals. The committee believes a more efficient mechanism for encouraging the production of low-income rental housing can be designed than the variety of subsidies existing under present law.

The primary tax preferences provided for low-income housing under present law are tax-exempt bond financing, accelerated cost recovery deductions, 5-year amortization of rehabilitation expenditures, and special deductions for construction period interest and taxes. These preferences operate in an uncoordinated manner, result in subsidies unrelated to the number of low-income individuals served, and fail to guarantee that affordable housing will be provided to the most needy low-income individuals.

Certain of the existing Federal tax subsidies are not targeted to persons of truly low-income. A recent study by the General Accounting Office[1] (GAO) of tax-exempt bond financed residential rental projects concluded that above-average income renters can qualify as "low" or "moderate" income for two reasons. First, defining such persons as those with incomes of no more than 80 percent of area median income results in an income ceiling that is relatively high, particularly when compared with the median renter income nationwide. Second, household incomes are not required to be adjusted for family size. Providing a tax credit for households with incomes not exceeding 50 percent of area median income and requiring family size adjustments, better targets those persons truly in need of low-income housing.

Another shortcoming of the existing tax subsidies is that none limits the rents that may be charged to low-income individuals. The same GAO study found, for example, that while 96 percent of individuals with incomes over 80 percent of area median income (the present ceiling on "low" or "moderate" income) paid rents of less than 30 percent of their income, only 37 percent of individuals with incomes below 80 percent of area median paid rents of less than 30 percent of their income.

The low-income housing tax credit, however, limits the rent that may be charged to a low-income tenant, and therefore ensures that the subsidized housing is affordable to low-income individuals. In return for providing housing at reduced rents, owners of rental housing receive a tax credit designed to compensate them for the rent reduction.

Another weakness of the existing tax subsidies is that, beyond a minimum threshold requirement of low-income units that must be served, the degree of subsidy is not directly linked to the number of units serving low-income persons. As a result, there is no incentive to provide low-income units beyond the minimum required. The amount of low-income housing credits which an owner may receive, however, is directly related to the amount of rental units made

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[1] United States General Accounting Office, *Report to the Chairman, Joint Committee on Taxation, Rental Housing: Costs and Benefits of Financing with Tax-Exempt Bonds*, GAO/RCED-86-2, February 1986.

available to low-income individuals. By providing tax credits which are based on the number of units serving low-income persons, a positive incentive is provided for more low-income households to be served. Moreover, two credit rates are provided, with the highest credit rate being available for units occupied by the lowest income individuals.

The committee believes the low-income housing tax credit will more effectively serve both low-income individuals and owners willing to provide affordable low-income housing than the present tax preferences for low-income housing.

Explanation of Provision

Overview

The bill provides a new tax credit that may be claimed by owners of residential rental projects providing low-income housing. The credit is claimed annually for a period of 10 years. The credit rate is set so that the annualized credit amounts have a present value of 60 percent or 30 percent of the basis attributable to qualifying low-income units, depending on the income of the tenant qualifying the unit for the credit. For projects on which construction commences prior to 1988, the annual credit rate is 8 percent for units occupied by individuals with incomes of 50 percent or less of area median (as adjusted for family size) and 4 percent for a limited number of units occupied by individuals with incomes of between 50 percent and 70 percent of area median. For projects on which construction begins after 1987, the Secretary is directed to adjust the credit rates to maintain the present values of the annualized credit amounts of 60 percent and 30 percent.

Residential rental projects providing low-income housing are eligible for the credit only if, for a period of 15 years from the beginning of the first taxable year in which the project qualifies for the credit, a minimum of 20 percent of the housing units in the project are occupied by individuals with incomes of 50 percent or less of area median income (determined on a continuing basis)[2] and the rent charged to tenants in units with respect to which the credit is allowable does not exceed a specified amount.

Newly constructed buildings and newly acquired existing structures that are substantially rehabilitated are eligible for the credit. Substantial rehabilitation is defined as rehabilitation expenditures made over a two-year period (or five-year period in the case of rehabilitation conducted subject to a comprehensive plan) of at least 22.5 percent of the acquisition cost of the project (other than for the cost of land).

Credit amount

An annualized tax credit with a present value of 60 percent of the basis attributable to units occupied by individuals with incomes of 50 percent of area median income or less is provided, subject to continuing compliance requirements. The annualized credit is provided in level annual amounts for 10 years.

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[2] This requirement is referred to as the "minimum set-aside" requirement.

A tax credit with a present value of 30 percent of the basis attributable to units occupied by individuals with incomes between 50 and 70 percent of area median income is provided, subject to continuing compliance requirements. The annualized credit is provided in level annual amounts for 10 years. The aggregate basis and number of such units occupied by individuals with incomes between 50 and 70 percent of area median qualifying for the credit may not exceed 30 percent of the total basis of (and number of units in) the entire project.

A taxpayer's credit amount in any taxable year is computed by applying the appropriate credit percentage to the qualified basis amount in such year.

Credit percentage

Initial annual credit percentages of 8 percent and 4 percent, reflecting an annuity due (i.e., the first payment is not discounted) with a present value of 60 or 30 percent (assuming a 7.06 percent after-tax annual interest rate), are provided for projects on which construction (including rehabilitation) commences prior to January 1, 1988. The bill directs the Treasury Department to make monthly adjustments to the credit percentages in such a manner that the credits have a present value of 60 percent and 30 percent for projects on which construction begins after 1987. The applicable credit percentages for projects on which initial construction begins after 1987 are the credit percentages determined for the month in which construction begins.

The Treasury's monthly adjustments of the credit percentages are to be determined on an after-tax basis, based on the average of the applicable Federal rates (AFR) for mid-term and long-term obligations. The after-tax interest rate is to be computed as the product of (1) the average AFR and (2) one minus the maximum individual statutory Federal income tax rate.

Qualified basis

Two separate qualified basis amounts for each building must be determined to compute the credit amount. One basis is calculated for the qualifying basis attributable to units occupied by individuals with incomes of 50 percent of area median income or less, and a second basis is calculated for the qualifying basis attributable to units occupied by individuals with incomes of between 50 percent and 70 percent of area median income.

Each qualified basis amount is determined in a similar manner, and each is generally proportional to the total depreciable basis in a building. Each qualified basis amount is equal to the percentage of units in a building occupied by tenants with the appropriate income (i.e., 50 percent or less of area median or between 50 and 70 percent of area median) multiplied by the total basis of the building and common areas attributable to the building, provided all units are substantially comparable. The cost of amenities, such as carpeting and appliances, may be included in the total basis of the building, provided the included amenities are comparable in all units. Additionally, the allocable cost of tenant facilities, such as swimming pools, other recreational facilities, and parking areas, may be included provided there is no separate fee for the use of

these facilities and they are made available on a comparable basis to all tenants in the project. (*See* generally, Treas. Reg. sec. 1.103–8(b)(4)(iii).)

The percentage of units used in this computation is the lesser of the actual percentage of units or the percentage of floor space in those units relative to total floor space in all units in the building. Only depreciable costs may be included in the computation of the qualified basis.

In the case of newly acquired existing property that is substantially rehabilitated, the total basis of the building which is allocated proportionately to the qualified basis amounts includes both the acquisition cost of the building and rehabilitation expenditures. The rehabilitation expenditures are reduced by any rehabilitation credit received before they are included in the total basis of the building. Further, rehabilitation expenditures may be included in basis and counted for purposes of the 22.5-percent-of-acquisition-cost test only if the expenditures do not improve any units in the project beyond comparability with units with respect to which the credit is allowable.

The qualified basis for each building is determined on the last day of the first taxable year in which the building is placed in service or, at the taxpayer's option, on the last day of the following taxable year if the building was in service less than 12 months during the first taxable year.

The first year the credit is claimed, the allowable credit amount is reduced using averaging conventions to reflect the time units comprising the qualified basis were occupied by low-income individuals during the year. To the extent there is such a reduction of the credit amount in the first year, an additional credit in the amount of such reduction is available in the eleventh taxable year. (This adjustment does not affect the amount of initial basis against which the credit is claimed in subsequent years of the 10-year credit period.)

Additions to qualified basis

The qualified basis of a building may be increased subsequent to the initial determination only if additional units in the building become occupied by individuals with incomes of 50 percent or less of area median. Credits claimed on such additional units are determined using a credit percentage equal to two-thirds of the credit percentage allowable for the initial qualified basis. Unlike credits claimed on the initial qualified basis, credits claimed on additions to qualified basis are allowable annually for the remainder of the required 15-year compliance period, regardless of the year such additional units begin to qualify for the credit. The cost of such additional units is determined by reference to the original basis (i.e., before cost recovery deductions commenced) of the units. The credit amount on the additional qualified basis is adjusted in the first year such additions are made using averaging conventions to reflect the time units comprising the additional qualified basis were occupied by qualifying individuals during the year.

The qualified basis of a building attributable to units occupied by individuals with incomes greater than 50 percent and less than or

equal to 70 percent of area median may not be increased after the initial year in which the qualified basis is determined.

A building placed in service after the date that the initial building in a common project is certified as eligible for the credit, is eligible for the same unreduced credit percentages applying to the first building on both the qualifying basis attributable to units occupied by individuals with incomes of 50 percent or less of area median and the qualifying basis attributable to units occupied by individuals with incomes between 50 percent and 70 percent of area median (subject to the 30 percent maximum for these units). Common facilities must be allocated in an appropriate manner to all buildings (whether existing or to be constructed) in the project, before being allocated proportionately to the qualifying basis amounts in the new building.

Required set-aside for low-income tenants

Residential rental projects providing low-income housing qualify for the credit only if 20 percent or more of the aggregate residential rental units in all existing buildings in a project are occupied by individuals with incomes of 50 percent or less of area median income, as adjusted for family size. Additionally, the percentage of floor space in these units must equal at least 20 percent of the aggregate floor space of all housing units in all existing buildings in the project. In no case is a unit considered to be occupied by low-income individuals if all of the occupants of such unit are students (as determined under sec. 151(c)(4)), no one of whom is entitled to file a joint income tax return.

The set-aside requirement must be met within 12 months of the date a building (or rehabilitated building) is placed in service, and complied with continuously thereafter for a period of 15 years beginning on the first day of the first taxable year in which the credit is claimed.

Special rules apply to projects consisting of multiple buildings placed in service on different dates. The initial building, within 12 months of being placed in service, must meet the set-aside requirement determined only by reference to those units in the building. When a second or subsequent building is placed in service, the project must meet the set-aside requirement with respect to the units in all buildings placed-in-service up to that time within 12 months of the date the second or subsequent building is placed in service.[3]

Subsequent buildings are subject to separate 15-year compliance periods. After the 15-year period has expired on an initial building, but while other buildings are still subject to the compliance period, the project must meet the set-aside requirement determined by reference to either all buildings or all buildings subject to the compliance period, at the taxpayer's option.

The determination of whether a tenant qualifies for purposes of the low-income set-aside is made on a continuing basis, rather than only on the date the tenant initially occupies the unit. An increase in a tenant's income may, therefore, result in a unit ceasing to

[3] Until the expanded requirement is met, the set-aside requirements determined by reference to all previously existing buildings must be continuously satisfied.

qualify as occupied by a low-income person. However, a qualified low-income tenant is treated as continuing to be such notwithstanding *de minimis* increases in his or her income. Under this rule, if a tenant qualifies as having an income of 50 percent or less of area median when initially occupying a housing unit, that tenant will be treated as continuing to have such an income as long as his or her income does not increase to a level more than 40 percent in excess of the maximum qualifying income, adjusted for family size. However, if the tenant's income increases to a level more than 40 percent above the otherwise applicable ceiling (or if the tenant's family size decreases so that a lower maximum family income applies to the tenant) that tenant may no longer be counted in determining whether the project satisfies the set-aside requirement. In the case of tenants having income between 50 percent and 70 percent of area median on initially occupying a unit and qualifying the unit for the credit, 20 percent is substituted for 40 percent in applying this requirement. (For a discussion of the rules for complying with the set-aside requirements, see the section *Compliance period and penalty for noncompliance*, below.)

As stated above, the bill requires that adjustments for family size be made in determining the area median incomes used to qualify tenants as having low income. In general, these adjustments are the same as the adjustments presently made under section 8 of the United States Housing Act of 1937. Thus, for a project which qualifies by setting aside 20 percent of the units for tenants having incomes of 50 percent or less of area median income, a family of four generally will be treated as meeting this standard if the family has an income of 50 percent or less of the area median income; a family of three having an income of 45 percent or less generally will qualify; a family of two having an income of 40 percent or less generally will qualify; and, a single individual having an income of 35 percent or less generally will qualify. The committee is aware that, in certain cases, the use of section 8 guidelines may result in qualifying incomes below the amounts reflected by these percentages because of dollar ceilings that are applied under the section 8 program.

Vacant units, formerly occupied by low-income individuals, may continue to be treated as occupied by a qualified low-income individual provided reasonable attempts are made to rent the unit and no other units of comparable or smaller size in the project are rented to nonqualifying individuals.

Gross rent limitation

The gross rent paid by families in units qualifying for the credit may not exceed 30 percent of the applicable qualifying income for a family of its size. Gross rent is to include the cost of any utilities, other than telephone. If any utilities are paid directly by the tenant, the maximum rent that may be paid by the tenant is to be reduced by a utility allowance prescribed by the Secretary, after taking into consideration the procedures under section 8 of the United States Housing Act of 1937.

Qualified low-income housing projects

Definition of project

A qualified residential rental project includes a building containing residential rental units and other property that is functionally related and subordinate to the function of providing residential rental units. A project may include multiple buildings having similarly constructed housing units, provided the buildings are located on the same tract of land, are owned by the same person for Federal income tax purposes, and are financed pursuant to a common plan of financing.

Residential rental units are eligible for the credit if the units are constructed for use by the general public and are used on other than a transient basis. In addition, each residential rental unit must include separate and complete facilities for living, sleeping, eating, cooking, and sanitation. Units eligible for the credit must be suitable for occupancy on a continuing basis. Hotels, dormitories, hospitals, nursing homes, and trailer parks are not qualified residential rental projects. (*See*, e.g., Treas. Reg. sec. 1.103–8(b)(4)(i).)

Residential rental property may qualify for the credit even though a portion of the building in which the residential rental units are located is used for a commercial use. No portion of the cost of such commercial-use property may be allocated to the cost of the low-income units. The committee intends that the costs of such a mixed-use facility may be allocated according to any reasonable method that properly reflects the proportionate benefit to be derived, directly or indirectly, by the residential rental units and nonqualifying property. (*See, e.g.,* Prop. Treas. Reg. 1.103–(8)(b).)

Compliance period and penalty for noncompliance

Qualified residential rental projects must remain as rental property and must satisfy the minimum set-aside requirement, described above, throughout a prescribed compliance period. Low-income units comprising the qualified basis on which additional credits are based are required to comply continuously with all requirements in the same manner as units satisfying the minimum set-aside requirement.

Units in addition to those meeting the minimum set-aside requirement on which a credit is allowable must also continuously comply with the income requirement. If a tenant initially qualified a unit for the credit due to an income of between 50 and 70 percent of area median, such a tenant will be treated as continuing to have a qualifying income provided his or her income does not increase to a level more than 20 percent in excess of the maximum qualifying income, adjusted for family size (e.g., for a family of four, not in excess of 84 percent of area median income). For a tenant qualifying a unit for the credit due to an income of 50 percent or less of area median, such a tenant will be treated as continuing to have a qualifying income provided his or her income does not increase to a level more than 40 percent in excess of the maximum qualifying income, adjusted for family size (e.g., for a family of four, not in excess of 70 percent of area median income).

The bill defines the compliance period as the period beginning on the date on which the building or project first meets the set-aside

requirement and ending 15 years from the first day in the first taxable year in which the set-aside requirement was met. The minimum set-aside requirement must be met, in all cases, within 1 year of the date the building (or rehabilitated property) is placed in service.

Within 90 days of the end of the first taxable year for which the credit is claimed and for each taxable year thereafter during the compliance period, the taxpayer must certify to the Secretary that the project has continuously complied with the set-aside requirement and report the dollar amount of each qualified basis on which the credit is computed. Additionally, the certification must include the date construction on the project began, which determines the applicable credit percentages.

The penalty for a project's noncompliance with the minimum set-aside requirement, the gross rent requirement, or the anti-double-dipping provisions (explained below) during the 15-year compliance period is recapture of the credit for the entire project. The credit would be recaptured fully for violations of the minimum set-aside requirement and other compliance requirements during the 10-year period in which credits are allowable on the set-aside units. For violations after year 10, but before expiration of the 15-year compliance period, the credit is recaptured partially in the following amounts: violations occurring after year 10 but before expiration of year 11 result in 85-percent recapture; after year 11 but before expiration of year 12 result in 70-percent recapture; after year 12 but before expiration of year 13, a 55-percent recapture; after year 13 but before expiration of year 14, 40-percent recapture; and after year 14 but before expiration of year 15, in 25-percent recapture.

In the case of projects with multiple buildings placed in service on different dates, the committee understands that such projects will have multiple compliance periods. In general, the committee intends that a reduction in the qualified basis of one building may be offset by an increase in the qualified basis of another building. In such a case, the qualified basis will be deemed to be transferred to the other building's qualified basis for the remainder of the compliance periods of all affected buildings. Such a transfer would result in no recapture and no additional credit if the changes in qualified basis were of equal amounts.

The penalty for noncompliance with respect to a decrease in the percentage of the low-income units upon which all credits have been or are being claimed, while still satisfying the set-aside requirement, is recapture of the credit for that portion of the qualified basis no longer in compliance. These credits are recaptured fully for violations in the first 10 years, and in partial amounts for violations thereafter, using the same percentages as for noncompliance with the minimum set-aside requirement and other compliance requirements.

Owners and operators of low-income housing projects on which a credit has been claimed must correct any noncompliance with the set-aside requirement or with the qualified basis amounts on which the credit is computed within a reasonable period after the noncompliance is discovered or reasonably should have been discovered. The committee does not intend, however, that tenants be evicted to return a project to compliance. Rather, the committee in-

tends that each residential rental unit of comparable or smaller size that becomes vacant while a project is not in compliance must be rented to a tenant having a qualifying income before any units in the project are rented to tenants not so qualifying until the project again is in compliance. In general, therefore, the event that gives rise to the penalty for noncompliance (i.e., recapture) will be rental of a unit to other than a low-income tenant (on other than a temporary basis) during any period when the project does not comply with the set-aside requirement or with the qualified basis amounts on which the credit is computed (or would not qualify as a result of that rental).

An example of how the recapture provisions operate follows. Assume credits are claimed for a project based on a qualified basis of 30 percent of the basis of the project being allocable to units occupied by individuals with incomes of 50 percent or less of area median income; and at a later date, a qualified basis of only 25 percent of the basis of the project is allocable to units occupied by individuals with incomes of 50 percent or less of median income, due to vacancies filled by tenants with nonqualifying incomes. Because the minimum set-aside requirement is not violated, recapture occurs only on the credit amounts allocable to the 5 percent basis of the project no longer eligible for the credit. If the reduction occurs in the first 10 years of the compliance period, the credit amounts allocable to such 5 percent of basis are recaptured fully.

If the maximum credit for which a project is eligible increases and subsequently decreases, a last-in, first-out rule is applied in determining which credits are recaptured. For example, consider a building that initially claimed a credit based on a qualified basis of 25 percent of the basis of the building allocable to units occupied by individuals with incomes of 50 percent or less of area median income, and in year 3 began receiving a credit based on an additional 10 percent of the basis of the building (i.e., a total of 35 percent). The credit amount on the additions to qualified basis is computed by reference to two-thirds of the credit percentage. If in year 5 the project is in noncompliance because only 30 percent of the basis of the building qualifies, recapture applies only to the credit amount computed on the additional 5 percent of the qualified basis of the building for which credits were claimed since year 3. Similarly, had the violation occurred after year 10 and before expiration of year 11, the recaptured amount would equal 85 percent of the credit amounts based on the 5 percent of the basis of the building claimed since year 3.

Transferability

A new purchaser of a project during the period for which the property is eligible to receive the credit is eligible to continue to receive the credit as if the purchaser were the original owner, using the same original basis as used by the original owner. Rehabilitation expenditures on such property may not be added to the basis. Credits will be recaptured upon a transfer unless the new purchaser agrees to assume full liability for recapture for noncompliance from the initial date credits were allowable with respect to the project.

Coordination with other provisions

Anti-double-dipping provisions

Projects are not eligible for the credit unless several additional conditions are met. First, a project is not eligible for the credit if any part of the project is financed with obligations on which the interest is exempt from Federal taxation under Code section 103. This restriction applies as long as any of those obligations remain outstanding.

Second, projects receiving direct Federal interest subsidies are not eligible for the credit while those subsidies continue. Direct Federal interest subsidies include such programs as programs comparable to HUD section 236, HUD section 221(d)(3), or FmHA section 515 loan programs.

Third, projects receiving Federal construction or rehabilitation funds or other Federal grants also would be ineligible for the credit. Examples of such programs include Community Development Block Grants, Urban Development Action Grants, Rental Rehabilitation Grants, and Housing Development Grants.

Projects receiving direct Federal rental assistance, such as through the HUD section 8 housing program, are not ineligible for the credit, but units occupied by tenants on behalf of whom such assistance is provided are not considered to meet the low-income standards for purposes of the set-aside requirement or credit eligibility.

Projects placed in service after December 31, 1986, which due to transitional exceptions contained in the bill, may be eligible for a cost recovery period for real property shorter than 27½ years (including five-year amortization (sec. 167(k)), or investment tax credits (other than the rehabilitation percentage), are not eligible for the low-income housing credit.

Other provisions

The credit is subject to the rules of the general business credit, including the maximum amount of income tax liability that may be reduced by a general business tax credit in any year. Unused credits for any taxable year may be carried back to each of the three preceding taxable years and then carried forward to each of the 15 following taxable years.

For purposes of the rules in the bill limiting passive loss deductions, the credit is treated as arising from rental real estate activities in which the taxpayer materially participates, and is subject to the limitations imposed on tax credits from such activities.

The basis of a project for depreciation is not reduced by the amount of low-income credits claimed.

Effective Date

The credit is effective for property placed in service after December 31, 1986.

Revenue Effect

The low-income housing credit is estimated to reduce fiscal year budget receipts by $60 million in 1987, $201 million in 1988, $312 million in 1989, $426 million in 1990, and $536 million in 1991.

E. Real Estate Investment Trusts (secs. 1431–1438 of the bill and secs. 856, 857, and 6697 of the Code)

Present Law

Overview

In general, a real estate investment trust ("REIT") is an entity that receives most of its income from passive real estate related investments and that receives conduit treatment for income that is distributed to shareholders. If an entity meets the qualifications for REIT status, the portion of its income that is distributed to the investors each year generally is taxed to the investors without being subjected to a tax at the REIT level; the REIT is subject to a corporate tax only on the income that it retains and on certain income from property that qualifies as foreclosure property. Thus, the REIT may serve as a means whereby numerous small investors can have a practical opportunity to invest in a diversified portfolio of real estate assets and have the benefit of professional management.

In order to qualify as a REIT and thereby receive conduit treatment, an entity must satisfy four tests on a year-by-year basis: organizational structure, source of income, nature of assets, and distribution of income. These tests are intended to allow conduit treatment in circumstances in which a corporate tax otherwise would be imposed, only if there really is a pooling of investment arrangement that is evidenced by its organizational structure, if its investments are basically in real estate assets, and if its income is passive income from real estate investment, as contrasted with income from the operation of business involving real estate. In addition, substantially all of the entity's income must be passed through to its shareholders on a current basis.

Taxation of REITs

Overview

In general, if an entity qualifies as a REIT by satisfying the various requirements described below, the entity is taxable as a corporation on its "real estate investment trust taxable income" ("REITTI"), and also is taxable on certain other amounts. REITTI is the taxable income of the REIT with certain adjustments. The most significant adjustment is a deduction for dividends paid. The allowance of this deduction is the mechanism by which the REIT becomes a conduit for income tax purposes. Other adjustments to taxable income that are made in arriving at REITTI are (a) the corporate dividends received deduction is not allowed, (b) adjustments attributable to a change in accounting period are not taken into account, (c) net income from foreclosure property (described below) is

excluded,[1] (d) net income (or loss) from prohibited transactions (described below) is excluded (or added), and (e) the amount of tax payable on account of unintentional failure to satisfy the income requirements is deducted.

Capital gains

A REIT that has a net capital gain for a taxable year generally is subject to tax on such capital gain under the alternative capital gains tax regime generally applicable to corporations. However, the REIT may diminish or eliminate its tax liability attributable to such capital gain by paying a "capital gain dividend" to its shareholders. A capital gain dividend is any dividend or part of a dividend that is designated by the payor REIT as a capital gain dividend in a written notice mailed to shareholders within 30 days after the end of the taxable year in which the dividend is paid. Shareholders who receive capital gain dividends treat the amount of such dividends as long term capital gain regardless of their holding period of the stock.

The amount of dividends that a REIT may designate as capital gain dividends may not exceed its REITTI for the taxable year (determined without regard to the dividends paid deduction). The practical effect of this limitation is that any net operating losses of the REIT will offset the amount of income eligible for preferential capital gain treatment. Such offsetting is the normal rule for corporations that have both capital gains and net operating losses. However, this offsetting results in less income receiving capital gains treatment than would be the case if an individual had both capital gains and net operating losses, because individuals are afforded an exclusion for a portion of their capital gains, rather than an alternative tax.

Income from foreclosure property

A REIT is subject to tax at the highest rate of tax paid by corporations on its net income from foreclosure property. Net income from foreclosure property is the excess of the sum of gains from foreclosure property that is held for sale to customers in the ordinary course of a trade or business and gross income from foreclosure property (other than income that otherwise would qualify under the 75 percent income test described below) over all allowable deductions directly connected with the production of such income.

Foreclosure property is any real property or personal property incident to such real property that is acquired by a REIT as a result of default or imminent default on a lease of such property or indebtedness secured by such property, provided that (unless acquired as foreclosure property), such property was not held by the REIT for sale to customers. Limitations are imposed on the period of time that property may be considered to be foreclosure property, and on the ability of REITs to operate foreclosure property other than through an independent contractor.

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[1] The amount of the dividends paid deduction is computed without regard to the the amount of dividends attributable to such income, however.

Income or loss from prohibited transactions

In general, a REIT must be an entity that is not engaged in any trade or business activities and that derives its income from passive sources. Accordingly, a 100 percent tax is imposed on the net income of a REIT from "prohibited transactions." A prohibited transaction is the sale or other disposition of property described in section 1221(1) of the Code (property held for sale in the ordinary course of a trade or business) other than foreclosure property. Thus, the 100 percent tax on prohibited transactions ensures that the REIT is a passive entity and may not engage in ordinary retailing activities such as sales to customers of condominium units or subdivided lots in a development project. Net income or net loss from prohibited transactions is determined by aggregating all gains from the sale or other disposition of property (other than foreclosure property) described in section 1221(1) with all losses and other deductions that are directly connected with the sale or other disposition of such property. A safe harbor is provided for certain sales which might otherwise be considered prohibited transactions.

Organizational structure requirements

To qualify as a REIT, an entity must be for its entire taxable year a corporation or an unincorporated trust or association that would be taxable as a domestic corporation but for the REIT provisions, and must be managed by one or more trustees. The beneficial ownership of the entity must be evidenced by transferable shares or certificates of ownership held by 100 or more persons.[2] The entity may not be so closely held by individuals that it would be treated as a personal holding company if all its adjusted gross income constituted personal holding company income.[3] The entity must be a calendar year taxpayer unless it was in existence as a REIT for any taxable year beginning prior to October 4, 1976. Certain financial institutions and life insurance companies may not qualify as REITs.

Income requirements

Overview

To meet the income requirements, at least 75 percent of the entity's income (excluding gross income from prohibited transactions) must be from rents from real property, interest on obligations secured by mortgages on real property or on interests in real property,[4] gain from the sale or other disposition of real property (including interests in real property and interests in mortgages on real property), dividends or distributions from another REIT, gain from

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[2] This requirement is considered to be met if it is satisfied for 335 days out of a 12 month taxable year or a proportionate part of a shorter taxable year.

[3] A corporation at least 50 percent of whose stock is held directly or indirectly by or for five or fewer individuals at any time during the last half of its taxable year is treated as a personal holding company if at least 60 percent of its ordinary adjusted gross income for the taxable year comprises personal holding company income (sec. 542). The entity is required to keep records for the purpose of determining actual ownership of interests in the entity for this purpose. *See* Treas. Reg. sec. 1.857-8.

[4] Commitment fees relating to an agreement to make loans, which would be secured by real property also are treated as qualifying income.

the disposition of interests in a REIT,[5] abatements or refunds of taxes on real property, and income or gain derived from property that qualifies as foreclosure property.

In addition, at least 95 percent of the entity's gross income (excluding gross income from prohibited transactions) must be derived from the sources qualifying for the 75 percent test or from other interest, dividends, or gains from the sale of stock or securities. Less than 30 percent of the entity's gross income may be derived from gain from the sale or other disposition of stock or securities held for less than the applicable holding period for long term capital gain or loss treatment,[6] real property held less than four years (other than foreclosure property, or property subject to an involuntary conversion within the meaning of section 1033), and property that is sold or disposed of in a prohibited transaction.

Definition of rents

In general.—For purposes of the income requirements, rents from real property generally include rents from interests in real property, charges for services customarily rendered or furnished in connection with the rental of real property, whether or not such charges are separately stated, and rent attributable to personal property that is leased under or in connection with a lease of real property, but only if the rent attributable to such personal property does not exceed 15 percent of the total rent for the year under the lease.[7]

Amounts are not treated as rents from real property, however, if the amount of such rent is determined in whole or in part based on the net income or profits derived by any person from the use of such property. Rents based on a fixed percentage of gross receipts or sales does not violate this requirement, however.[8] In addition, amounts are not treated as qualifying rent if received from certain parties in which the lessor has an interest of 10 percent or more. Further, where the entity furnishes or renders services to the tenants of rented property, amounts received or accrued with respect to such property are not treated as qualifying rents unless the services are furnished through an independent contractor. In general, an independent contractor is a person who does not own more than a 35 percent interest in the REIT, and in which no more than a 35 percent interest is held by persons with a 35 percent or greater interest in the REIT.

Customary services.—In general, services provided to tenants are regarded as customary if, in the geographic market within which the building is located, tenants in buildings that are of a similar class (for example, luxury apartment buildings) are customarily provided with the service. The furnishing of water, heat, light, and air conditioning, the cleaning of windows, public entrances, exits,

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[5] Gains on the sale of interests in a REIT would not qualify if such interests were treated as property held for sale to customers in the ordinary course of business.

[6] *E.g.*, six months for property acquired after June 22, 1984 and before January 1, 1988.

[7] The allocation of rent to the real and personal properties under a lease generally is based on the relative adjusted bases of the leased properties. If the rent attributable to personal property under this allocation is greater than 15 percent of the total rent under the lease, then all rent attributable to personal property from the lease will be treated as nonqualifying income.

[8] Similar rules apply in determining whether interest income is treated as qualifying income.

and lobbies, the performance of general maintenance, and of janitorial and cleaning services, the collection of trash, the furnishing of elevator services, telephone answering services, incidental storage space, laundry equipment, watchman or guard service, parking facilities and swimming pool facilities are examples of services that are customarily furnished to tenants of a particular class of buildings in many geographical marketing areas (Treas. Reg. sec. 1.856–4(b)).

Asset requirements

To satisfy the asset requirements to qualify for treatment as a REIT, at the close of each quarter of its taxable year, an entity must have at least 75 percent of the value of its assets invested in real estate assets, cash and cash items, and Government securities. Moreover, not more than 25 percent of the entity's assets can be invested in securities of any one issuer (other than a government or a REIT), which securities comprise more than five percent of the entity's assets or more than 10 percent of of the outstanding voting securities of such issuer. The term real estate assets is defined to mean real property (including interests in real property and mortgages on real property) and interests in REITs. Interests in real property include fee ownership and co-ownership of land or improvements thereon, leaseholds of land or improvements thereon, options to acquire land or improvements thereon, and options to acquire leaseholds of land or improvements thereon, but do not include mineral, oil, or gas royalty interests.

Distribution requirements

Overview

To satisfy the distribution requirement, an entity must distribute as dividends to its shareholders during the taxable year an amount equal to at least the excess of (a) the sum of (i) 95 percent[9] of its REITTI other than capital gains income, and (ii) 95 percent[10] of the entity's net income from foreclosure property less the tax imposed on such income, over (b) the sum of (i) penalty taxes imposed under section 6697 (resulting from the distribution of "deficiency dividends") and (ii) the net loss from prohibited transactions.

Distributions after the taxable year

Certain distributions within 12 months of the end of the taxable year.—If a REIT declares a dividend prior to the time for filing its tax return for a taxable year and actually pays such dividend within 12 months of the end of such taxable year (but not later than the date of the next regular payment after the declaration), then the REIT may elect to have the dividend treated as having been paid in the preceding taxable year (sec. 858). Notwithstanding the election, the distributees are treated as having received the dividend in the year in which the distribution is made.

To partially compensate for the deferral of tax liability that may occur where a REIT pays such so-called "section 858 dividends," a

[9] This requirement is 90 percent for taxable years beginning before January 1, 1980.
[10] This requirement is 90 percent for taxable years beginning before January 1, 1980.

nondeductible three percent excise tax is imposed on the amount of such dividends to the extent that 75 percent of the REITTI of the REIT for the preceding taxable year without regard to the dividends paid deduction and certain other adjustments (as reported on the REIT's tax return) exceeds the amount distributed in such year (sec. 4981).[11]

Other distributions after the end of the taxable year—deficiency dividends.—Where, as a consequence of an audit by the Internal Revenue Service, there has been a "determination" that an "adjustment" is to be made to REITTI for a taxable year, the entity may pay a deficiency dividend to its shareholders and receive a deduction for such distributions with regard to the taxable year for which the election is made, provided that the adjustment did not occur as a result of fraud or willful failure to file an income tax return. If the proper amount is distributed as a deficiency dividend, the entity is not disqualified as a REIT or subject to tax on the amounts distributed (but is subject to interest and penalties). Interest and penalties relating to amounts distributed as deficiency dividends are based on the amount of the adjustment.[12]

In addition to other penalties provided under the Code relating to underpayments of tax, section 6697 of the Code imposes a penalty equal to the amount of interest attributable to the amount paid by a REIT as a deficiency dividend. The amount of this penalty is limited to one half of the amount of the deficiency dividend.

Reasons for Change

The committee believes that certain aspects of the requirements for qualification and taxation of REITs should be modified. Generally, the modifications are required in order to allow REITs to enter into transactions, or otherwise structure their affairs, in either case consistent with both prevailing market conditions and the general requirement that a REIT is an entity whose primary purpose is to derive most of its income from passive real estate related sources and distribute most of its income to its shareholders.

The committee understands that certain of the REIT requirements present significant difficulties in connection with the initial election by an entity of REIT status. For example, new corporations that are formed for the purpose of electing REIT status may have difficulty meeting the shareholder diversification requirement in their first year because of delays in the distribution of their shares. The committee believes that for the first year that an entity otherwise meets the requirements to elect REIT status, failure to meet the shareholder diversification requirement should not result in disqualification.

The committee also understands that a corporation that is formed for the purpose of becoming a REIT often may initially

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[11] Amounts counted toward the 75-percent requirement are only amounts that qualify for the dividends paid deduction for the current year. Therefore, any section 858 dividends or deficiency dividends (which relate only to a prior year) are not counted toward this 75-percent requirement.

[12] For this purpose, the amount of the adjustment would include adjustments attributable both to ordinary income and capital gains. However, no interest and penalties are assessed in the event of the late designation of a capital gains dividend where the amount was distributed previously as an ordinary income distribution.

adopt a fiscal year ending a few months after its incorporation, intending to change its taxable year to the calendar year required of REITs immediately after the end of the first fiscal year. The reason that this is done is that the new corporation would not be able to qualify as a REIT for its first taxable year if the calendar year were elected initially. In this situation, the committee believes that the entity should be permitted to change its taxable year to a calendar year without permission of the Internal Revenue Service.

The committee also believes that an entity wishing to elect REIT status for the first time should not be permitted to do so if it has earnings and profits accumulated as a C corporation. Accordingly, the bill provides that any C corporation having accumulated earnings and profits is required to distribute such accumulated earnings and profits in order for it to qualify as a REIT.

The committee also understands that both newly electing and existing REITs may encounter difficulty meeting the 75 percent income test after they receive a significant amount of new equity capital. For example, such amounts may be received as a result of a public offering of stock, but the process of investing such amounts in appropriate assets producing rents qualifying for the 75 percent income test may take sufficiently long so that the entity may not be able to satisfy the requirement for the year. The committee recognizes the impracticality of requiring REITs to identify their chosen real estate investments prior to raising any new equity capital, and believes that REITs should be afforded some relief from the 75 percent income test for one year after receiving the new equity capital. The committee believes, however, that consistent with the general passive nature of the REIT, that the relief should be available only to the extent that the income from the investment of new equity consists of income from either stock or debt instruments.

The committee understands that for purposes of limiting liability, separate parcels of real estate commonly are held in separate, but commonly owned, corporations. Since stock in a corporation other than a REIT is not treated as a real estate asset, REITs effectively are prevented from holding their real estate assets in separate corporations. The committee believes that whether a REIT is considered to meet the asset requirement should be determined by treating assets held by wholly owned subsidiaries as owned directly by the REIT.

The committee believes that two of the requirements of present law, that are intended to assure that the REIT is more a passive entity than one engaged in a trade or business, may be overly restrictive and should be liberalized consistent with maintaining the essential passivity of the REIT. First, the committee believes that REITs should be permitted to perform certain services in connection with the rental of real property without being required to use an independent contractor (to assure that rents from such property are considered to qualify as "rent from real property"). The committee believes that the same standard should be applied to REITs for the purpose of determining whether amounts being received are from the passive rental of real property or from an active trade or business, that is applied to tax-exempt entities in determining whether amounts are treated as income from an "unrelated trade

or business." Second, the committee believes that the prohibited transaction safe harbor of present law should be liberalized, in part by extending the safe harbor to include any number of transactions so long as the gross income from such transactions does not exceed a fixed percentage of the REIT's income.

The committee understands that lessors of real property frequently lease property to a prime tenant and agree to accept as rent a fixed amount plus a percentage of the prime tenant's profits from the rental of the property. Since the rent from the prime tenant is based in part on the prime tenant's net profits in such a transaction, the portion based on the net profits would not qualify as rents from real property for the REIT. Nevertheless, if the prime tenant's rent from the property is dependent only on rents received from the property, (including rents based on the gross receipts of the subtenants), then the REIT in this situation is not participating in the profits of any active business other than that pertaining to the rental of its own property. Accordingly, the committee believes that rents that are based on the net income of the tenant should be treated as qualifying rents for the REIT provided that the tenant's profits are derived only from sources that would be qualifying rent from real property if earned directly by the REIT.

If a REIT sells property in exchange for obligations bearing original issue discount, or enters into deferred rental agreements (within the meaning of sec. 467), the REIT may be required to recognize income in advance of receiving cash. Since the REIT's distribution requirement is based on its REITTI which does not necessarily take into account cash received, a REIT that uses the cash method of accounting and enters into such agreements (for example, because of market pressures to do so) might have to borrow up to 95 percent of the amount of income that it would not otherwise be required to recognize in order to meet its distribution requirement. A similar situation arises where the REIT enters into a transaction that it believes in good faith to meet the requirements for eligiblity as a tax-free exchange under section 1031, but the transaction later is determined not to qualify. The committee believes that REITs should be permitted some relief from the distribution requirement in these circumstances. The committee recognizes that the distribution requirement, which is 95 percent, already takes into account the possibility of the REIT having certain amounts of income not accompanied by cash, and that the relief extended should reflect this feature of the requirement. Accordingly, the bill reduces the amount that the REIT otherwise would be required to distribute by the amount that these types of noncash income exceed 5 percent of REITTI. In order that this relief not result in deferral of tax on the related income, the REIT is required pay tax on the undistributed amount.

Since satisfaction of the REIT's distribution requirement depends on the amount of dividends it distributes, whether a REIT is able to meet the distribution requirement depends in part on whether the amounts the REIT distributes may qualify technically as dividends under the Code. One requirement for a distribution to qualify as a dividend is that the payor must have either current or accumulated earnings and profits. Hence, a REIT may fail to satisfy

its distribution requirement because the amount of its distributions that are treated as dividends may be limited. The committee believes that the technical earnings and profits requirement should not prevent a REIT from meeting its distribution requirement, provided that the distributions are treated as taxable income to the shareholders. Accordingly, the bill clarifies present law in providing that a REIT would have adequate earnings and profits for the purpose of enabling it to meet the distribution requirement.

The committee believes that a fundamental purpose for permitting conduit treatment for REITs is to enable small individual investors the opportunity to invest in a professionally managed diversified portfolio of real estate assets. Hence, the committee believes that if a REIT is required to offset its capital gain income with net operating losses, individual investors routinely are denied the benefit of capital gain treatment that they would receive if they were able to hold the real estate assets directly. Thus, the bill provides that REITs may preserve the availability of capital gains treatment even if they have net operating losses. In addition, the committee believes that the notification procedure for capital gains dividends may be accomplished with less of a burden on the REIT if the REIT were permitted to mail its capital gain notices with its annual report, and the bill so provides.

Finally, the committee believes that the imposition of interest and penalties relating to deficiency dividends based on the full amount of such dividends adequately compensates the Federal government for the deferral of tax liability that takes place when a REIT distributes less than is required for a taxable year. Accordingly, the penalty tax under section 6697 is repealed under the bill.

Explanation of Provisions

Overview

The bill modifies many of the provisions relating to the requirements for qualification as and the taxation of REITs. The provisions modified relate to the general requirements for qualification as a REIT, the income and asset requirements for qualification as a REIT, the definition of rents and interest, the distribution requirements for qualification as a REIT, the treatment of capital gains, the provisions relating to prohibited transactions, and certain other provisions.

General requirements

Under the bill, as under present law, an entity generally may not elect REIT status if it would meet the stock ownership test of section 542(a)(2) (i.e., if it would be treated as a personal holding company if all of its income constituted personal holding company income) or if it had fewer than 100 shareholders. Under the bill, however, an entity that otherwise meets the applicable requirements may elect REIT status notwithstanding its meeting the section 542(a)(2) stock ownership test or its having fewer than 100 shareholders, provided that the entity was not a REIT in any prior year. In applying the attribution rules of section 544 for purposes of determining whether the stock ownership requirement of section 542(a)(2) is met for any taxable year, attribution to an individual of

stock owned by or for the individual's partner is ignored under the bill.

The bill provides that in order to elect REIT status, the electing entity must either have been treated as a REIT for all taxable years beginning after February 28, 1986, or must have no earnings and profits accumulated for any year in which the entity was in existence and not treated as a REIT.

The bill also provides that an entity that has not engaged in any active trade or business is permitted to change its annual accounting period to a calendar year without approval of the Internal Revenue Service in connection with electing REIT status. This rule is intended to apply to entities that are newly formed for the purpose of becoming a REIT, and that wish to adopt a calendar year taxable year after an initial period in which, for example, the entity receives the proceeds of a stock offering and temporarily invests such proceeds in passive investments until investment in suitable real estate assets is made.

Income and asset requirements

REIT subsidiaries

Under the bill, all the assets, liabilities, and items of income, deduction, and credit of a "qualified REIT subsidiary" are treated as the assets, liabilities, and respective items of the REIT that owns the stock of the qualified REIT subsidiary. A subsidiary of a REIT is a qualified REIT subsidiary if and only if 100 percent of the subsidiary's stock is owned by the REIT at all times that the subsidiary is in existence. If at any time the REIT ceases to own 100 percent of the stock of the subsidiary, or if the REIT ceases to qualify for (or revokes an election of) REIT status, such subsidiary is treated as a new corporation that acquired all of its assets in exchange for its stock (and assumption of liabilities) immediately before the time that the REIT ceased to own 100 percent of the subsidiary's stock, or ceased to be a REIT as the case may be.[13]

For example, an entity owns 100 percent of the stock of a corporation that holds an office building and receives rental income from the office building. For purposes of determining whether the shareholder entity qualifies for REIT status, the shareholder is treated as owning the office building directly and as receiving the rents therefrom. If the shareholder qualifies as a REIT, the separate existence of the 100 percent owned subsidiary is ignored for all income tax purposes. If the shareholder REIT sells all of the stock in the subsidiary to any purchaser (including another REIT), then the subsidiary is treated as a new corporation that was formed and that received its properties in exchange for its stock, immediately after which it was owned by the purchaser. Hence, the committee anticipates that the deemed transfer of the assets to the subsidiary in exchange for its stock would not qualify as a tax-free exchange under section 351 in this situation.

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[13] In the case of the shareholder REIT ceasing to be treated as a REIT, the committee intends that the transfer would be deemed to take place as of the first day of the first taxable year in which the entity's REIT status ceases.

New equity capital

Under the bill, if a REIT receives new equity capital, then income derived from stock or debt instruments (i.e., interest, dividends, or gains from the sale of such stock or debt instruments) that is attributable to the temporary investment of the new equity capital is treated, for a one-year period beginning on the date that the REIT receives such capital, as qualifying income for purposes of the "75 percent income test." [14] In addition, during such period, stock or debt instruments purchased with such capital are treated as "real estate assets" for purposes of the "75 percent asset test." Under the bill, new equity capital is any amount received by the REIT in exchange for stock of the REIT (other than pursuant to a dividend reinvestment plan).

Definition of rents and interest

Independent contractor requirement

Under the bill, amounts received by a REIT in connection with the rental of property do not fail to qualify as rents from real property merely because the REIT performs certain services and does not use an independent contractor for the provision of such services. Under the bill, the services that may be provided without violating the "independent contractor test" are those services the provision of which would not by reason of section 512(b)(3) result in the receipt of "unrelated business income" by an organization subject to tax on such income (sec. 511(a)(2)). Thus, under the bill, amounts received by the REIT in connection with the rental of real property would not fail to be treated as rents from real property if the REIT provides only certain services other than services that are considered rendered to the occupant of the property (Treas. Reg. sec. 1.512(b)–1(c)(5)). The bill does not alter the provision of present law under which amounts received by a REIT are treated as rents from real property if the REIT provides "customarily furnished services" to its tenants through an independent contractor.

Rents and interest based on net income

Under the bill, rents or interest that are based on the net income of a tenant or debtor are treated as rent from real property or as interest, respectively, if certain conditions are met. To qualify, the rent (or interest) must be received from a tenant (or debtor) that receives substantially all of its income from the leased property (or the property that secures the loan) from the subleasing (or leasing) of substantially all of such property, and the rent received by the tenant (or debtor) consists entirely of amounts that would be treated as rents from real property (or interest) if received directly by the REIT. The same rules that apply under present law apply under the bill if the tenant (or debtor) receives rents (or interest) from the property a portion of which would qualify as rents from real property (or interest) for the REIT and a portion of which would not, i.e. a proportionate part of the amount received by the REIT would be treated as rent from real property (or interest).

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[14] Nevertheless, the REIT would continue to be required to meet the "95 percent income test" including income from the new equity capital.

Distribution requirement

Under the bill, the minimum amount that the REIT is required to distribute (i.e., the minimum dividends paid deduction as specified in section 857(a)(1)), is reduced by a portion of certain amounts that the REIT is required to include in income in advance of receiving cash. These amounts are (a) amounts that the REIT is required to include in income under section 467 with respect to certain rental agreements involving deferred rents, (b) the amount of original issue discount that the REIT is required to accrue with respect to a loan to which section 1274 applies, and (c) any income arising from the disposition of a real estate asset, but only in circumstances where the REIT had entered into a transaction with respect to such real estate, had intended in good faith that the transaction qualify as a like-kind exchange under section 1031, the income is recognized as a result of a determination that the transaction did not so qualify, and the failure to meet the requirements of section 1031 was due to reasonable cause and not due to willful neglect. The portion of such amounts by which the REIT's minimum distribution requirement is reduced is the amount by which the sum of these amounts exceeds five percent of the REITTI of the REIT determined without regard to the REIT's dividends paid deduction and net capital gain.[15]

In addition, the bill provides that the amount of a REIT's current (but not accumulated) earnings and profits for a taxable year is to be not less than its REITTI (determined without regard to the dividends paid deduction) for the taxable year.

Capital gains

Under the bill, for purposes of determining the maximum amount of capital gains dividends that a REIT may pay for a taxable year, the REIT would not offset its net capital gain with the amount of any net operating loss, whether current or carried over from a previous taxable year. To the extent that the REIT then elects to pay capital gains dividends in excess of its net income, the REIT would increase the amount of its net operating loss carryover by such amount. For example, a REIT with no net operating loss carryovers incurs a $100 net operating loss and has a net capital gain of $50 in 1987. Under the bill, the maximum amount of capital gains dividends that the REIT could distribute is $50. If the REIT distributed a $40 capital gain dividend, its net operating loss carryover to the succeeding taxable year would be $90.

Under the bill, REITs are permitted to mail the required capital gain notices to shareholder with the REIT's annual report rather than within 30 days of the end of the taxable year. The committee intends that if the REIT does not regularly provide its shareholder with an annual report, then the notice requirement of present law would continue to apply.

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[15] The computation of REITTI would take into account the change made by the bill, which would permit the deduction of the REIT's net loss from prohibited transactions, as described below.

Prohibited transactions rules

The bill makes two modifications to the rules relating to prohibited transactions. First, the bill modifies the safe harbor under which sales by the REIT meeting the conditions of the safe harbor are not treated as prohibited transactions. Under the bill, the number of sales of property that a REIT may make within the safe harbor is increased from five to seven. In addition, the extent of expenditures that the REIT may make within four years of sale that are includible in the basis of the property is increased from 20 percent of the net selling price of the property to 30 percent. The bill also provides an alternative safe harbor whereby the REIT may make any number of sales during the taxable year, provided that the gross income from such sales does not exceed 15 percent of the REITTI of the REIT for the taxable year. A sale is treated as qualifying for the alternative safe harbor, however, only if substantially all the marketing and development expenditures with respect to the property sold were made through an independent contractor. The determination of whether a particular sale qualifies for the prohibited transaction safe harbor is made on a property by property basis.

Second, the bill provides that in determining the amount of net income derived from prohibited transactions, losses from prohibited transactions (and deductions attributable to prohibited transactions in which a loss was incurred) may not be taken into account. The bill does, however, provide that the amount of any net loss from prohibited transactions may be taken into account in computing REITTI. For example, for a taxable year a REIT has a net gain from a prohibited transaction of $100 and a net loss from a prohibited transaction of $50. The REIT has net rental income of $200 and no other items of income or deduction. Under the bill, the REIT would be subject to a $100 tax on the gain from its prohibited transaction, and its REITTI would be $150.

Deficiency dividends

Under the bill, the penalty tax under section 6697 on deficiency dividends is repealed.

Effective Date

The provisions of the bill are effective for taxable years beginning after December 31, 1986. The provision relating to the treatment as interest of certain amounts based on the net income of the debtor does not apply to amount received or accrued with respect to loans made before May 28, 1976 (or pursuant to a binding commitment entered into before May 28, 1976).

Revenue Effect

The provisions are estimated to decrease fiscal budget receipts by $12 million in 1987, $13 million in 1988, $13 million in 1989, $14 million in 1990, and $15 million in 1991.

F. Mortgage-Backed Securities (secs. 1441–1445 of the bill and secs. 1272, 6049, and 7701 and new secs. 860A–860E of the Code)

Present Law

Taxation of alternative methods of owning income producing assets

Overview

Under present law, income-producing assets (such as mortgages on residential property or other debt instruments) can be owned directly, or they can be owned indirectly by means of an equity interest in an intermediary entity. Income generated by property that is owned directly generally is taxed to the owner of the property. Thus, in the case of property owned directly by an individual, income from such property is subject to only one level of taxation. Income from property owned indirectly may be subject to more than one level of taxation, i.e., tax may be imposed both at the level of the intermediary holder and the indirect owner.

Whether more than one level of tax is imposed where income producing property is held indirectly generally depends on whether the intermediary entity is treated for tax purposes (1) as a separate taxable entity (such as a corporation or an association taxable as a corporation), (2) as a complete conduit entity (such as a partnership or S corporation), or (3) as a partial conduit entity (such as a trust or real estate investment trust) under which income is not taxed to the entity to the extent it is currently distributed to the entity's owners.

Direct ownership of income producing assets

Individual ownership

The most basic form of direct ownership of income producing assets is the holding of such assets by an individual. Where an individual owns income producing assets directly, the individual generally includes all income generated by the property, and deducts all items of expense related to the property. When the individual disposes of the property in a taxable transaction, the individual recognizes gain or loss, which may be capital gain or loss.

Grantor trusts

A grantor trust is an arrangement under which legal title to property is transferred to a trustee, but the transferor retains certain powers over, or interests in, the trust so that the transferors are treated as retaining direct ownership of such property for Federal income tax purposes (secs. 671–679). Thus, income, deductions,

and credits of the grantor trust are attributed directly to the grantors.[1]

Indirect ownership of income producing assets

Separate taxable entities—corporations

One form of indirect ownership of income producing property is the ownership of stock in a corporation that owns such property. Corporations can be used to hold investment property or to engage in the active conduct of a trade or business.

Corporations generally are treated for tax purposes as separate taxable entities, apart from their shareholders.[2] Thus, income earned by a corporation is taxed to the corporation. In addition, when the after-tax earnings of a corporation are distributed to the corporation's stockholders as dividends, generally such earnings also are taxed to the stockholders.[3]

Interest on debt incurred by a corporation to finance the acquisition of income-producing assets generally is deductible to the corporation incurring the debt. To the extent that income from debt-financed property is paid to the debtholders in the form of interest, the interest deduction offsets any corporate-level tax on such income, resulting in the imposition of only a single tax on the income, which tax is borne by the debtholder.

Complete conduit entities

Partnerships.—Another form of indirect ownership of income producing assets is ownership of an interest in a partnership holding such assets. A partnership generally is treated as a complete conduit for Federal income tax purposes.[4] Each partner accounts for his "distributive share" of the partnership's income, loss, deduction, and credit. The liability for income tax is that of the partner, and not of the partnership, without regard to whether the income of the partnership is actually distributed to the partners. Partnership losses, deductions, and credits pass through to the partners and can be used to offset other income. In general, an entity is treated as a partnership if it is an unincorporated organization through, or by means of which, any business, financial operation or venture is carried on, and it is not treated as a corporation, a trust, or an estate.[5]

S corporations.—Income producing property also may be owned indirectly through ownership of stock in an S corporation. Although S corporations are corporate entities, if a corporation so elects, its shareholders generally may account for a proportionate amount of the corporation's items of income, loss, deduction, and

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[1] In some cases, persons other than the transferors are treated as owners of the trust's assets.

[2] Certain corporations may be treated as complete or partial conduit entities, however. *See* discussion of S corporations and real estate investment trusts, below.

[3] Under present law, an individual generally is allowed to exclude from taxable income up to $100 of dividends per year ($200 for a joint return) (sec. 116). Corporations are entitled to a dividends received deduction for 85 or 100 percent of dividends received (secs. 243–245). Section 312 of the bill repeals the limited dividend exclusion for individuals, and section 311 of the bill reduces the 85 percent dividends received deduction for corporations to 80 percent.

[4] A partnership is treated as an entity separate from its partners for purposes of calculating items of taxable income, deduction, and credit. It also is treated as an entity for purpcses of reporting information to the Internal Revenue Service.

[5] *See* discussion of entity classification, below.

credit under subchapter S of the Code (secs. 1361 *et seq.*). The S corporation itself generally has no tax liability for as long as the election is in effect.[6]

In general, a domestic corporation may elect to be treated under subchapter S if it has 35 or fewer shareholders (none of whom are corporations or nonresident aliens), has not more than one class of stock, and is not a financial institution, a life insurance company, or one of several other types of corporations.

Partial conduit entities

Real estate investment trusts.—Another form of indirect ownership is the ownership of shares or interests in a real estate investment trust ("REIT"). Under the provisions of the Code applicable to REITs (secs. 856 *et seq.*), REITs generally are treated as conduits for Federal income tax purposes to the extent of the amount of its earnings that are distributed currently to shareholders. Conduit treatment is achieved by allowing the REIT a deduction for earnings distributed on a current basis. Thus, income that is currently distributed to shareholders is not taxed at the REIT level; income that is not currently distributed to shareholders is taxed at the REIT level, as in the case of ordinary corporations.

In general, an entity may qualify as a REIT if it is a trust or corporation with at least 100 different freely transferable interests, that would be taxable as an ordinary domestic corporation but for its meeting certain specified requirements. These requirements relate to the entity's assets being comprised substantially of real estate assets and the entity's income being in substantial part realized from certain real estate and real estate related sources.

The ability of a REIT to engage in regular business activities is limited by the requirement that income from the sale or other disposition of stock or securities held for less than 1 year, or real property held less than 4 years, must account for less than 30 percent of the REIT's income. Further, a 100 percent tax is imposed on gains from the sale of property held for sale to customers in the ordinary course of trade or business (other than foreclosure property).

If a corporation meets these requirements and elects to be treated as a REIT, it generally is subject to the regular corporate tax, but receives a deduction for dividends paid provided that the amount of its dividends paid is not less than an amount generally equal to 95 percent of its ordinary income. These dividends must be paid within a short period following the close of the REIT's taxable year and are generally includible as ordinary income to the shareholders.[7]

A REIT that realizes capital gain income may be subject to tax at the corporate level at capital gains rates. If, however, the REIT pays dividends out of such capital gains, the dividends are deductible by the REIT in computing its capital gains tax and are taxable as capital gains to the recipient shareholders.

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[6] An S corporation may be subject to tax at the entity level under certain limited circumstances.

[7] A deficiency dividend procedure was added to the REIT provisions as part of the Tax Reform Act of 1976 so that a REIT, acting in good faith but failing to satisfy the distribution requirement, could avoid disqualification.

RICs.—Conduit treatment similar to that granted to REITs also is provided to regulated investment companies ("RICs"). In general, a RIC is an electing domestic corporation that either meets or is excepted from certain registration requirements under the Investment Company Act of 1940 (15 U.S.C. 80), that derives at least 90 percent of its ordinary income from specified sources commonly considered passive investment income, that has a portfolio of investments that meet certain diversification requirements, that distributes at least 90 percent of its income to its shareholders annually, and that also meets certain other requirements.

The ability of a RIC to engage in an active buisness is limited by a requirement that less than 30 percent of the gross income of the RIC may be derived from gain on the sale or other disposition of stock or securities held for less than three months.

A RIC, like a REIT, generally is subject to the regular corporate tax, but receives a deduction for dividends paid to its shareholders. Rules similar to those applicable for REITs apply to distributions of capital gain dividends, and distributions of deficiency dividends.

Trusts.—Another form of indirect ownership of property is ownership of the beneficial interest of property that is held in a trust. A trust is an arrangement whereby trustees take title to property and become responsible for the protection and conservation of such property on behalf of the persons holding the beneficial interest in the property. A trust generally is treated as a partial conduit for Federal income tax purposes since the trust, although in form a separate taxable entity, is allowed a deduction for amounts distributed to its beneficiaries, which amounts generally are includible in the beneficiaries' income.

A fixed investment trust is a trust used to hold a diversified portfolio of investments for its beneficiaries. Generally, such a trust is treated as a trust for tax purposes (and not as an association) if the trustee does not have the power to vary the investments of the trust.[8]

Rules for classifying entities

Corporation or partnership

Under present law, Treasury regulations provide that whether a particular entity is classified as an association taxable as a corporation or as a partnership, trust, or some other entity not taxable as a corporation is determined by taking into account the presence or absence of certain characteristics associated with corporations. These characteristics are (1) associates, (2) an objective to carry on business and divide the gains therefrom, (3) continuity of life, (4) centralization of management, (5) liability for entity debts limited to entity property, and (6) free transferability of interests.[9] These regulations generally are based on the principle stated in *Morrissey* v. *Commissioner*, 296 U.S. 344 (1935), in which the Supreme Court held that whether an entity is treated as a corporation depends not on the form of its organization, but on whether it more closely resembles a corporate than a noncorporate entity.

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[8] *See* discussion of entity classification, below.
[9] Treas. Reg. sec. 301.7701-2(a).

Of the characteristics mentioned above, the first two are common to both corporate and partnership enterprises. Consequently, the remaining four factors are determinative of whether the entity is treated as a corporation or as a partnership. Treasury regulations state that the corporate characteristics of an entity must make it more nearly resemble a corporation than a partnership or a trust for the entity to be treated as a corporation.[10] Under this test, the Treasury regulations provide that most limited partnerships formed under the Uniform Limited Partnership Act are not treated as corporations since these entities generally do not possess continuity of life and also may lack limited liability.

Trust or association

Since both corporations and trusts generally possess centralization of management, continuity of life, free transferability of interests, and limited liability, the Treasury regulations provide that the determination of whether a particular unincorporated entity is treated as a trust or as an association taxable as a corporation depends on whether there are associates and an objective to carry on business and divide the gains therefrom.[11] Generally, if the purpose of an arrangement is to grant to trustees exclusive responsibility for the protection and conservation of trust property, and the persons with the beneficial interest in the property cannot share in the discharge of that responsibility, there are no associates or an objective to carry on business. Such an arrangement generally will be treated as a trust.[12] On the other hand, if a trust is used for carrying on a profit-making business that ordinarily would be carried on through a business organization such as a corporation or partnership, it will not be treated as a trust.[13] However, a trust that is used to hold income-producing assets may be treated as a trust if there is no power under the trust agreement to vary the investment.[14]

In May, 1984, the Treasury Department issued proposed regulations addressing the treatment of trusts that have more than one class of ownership interest. Final regulations were issued in March, 1985 (Treas. Reg. sec. 301.7701-4(c)(1)). Under these regulations, a trust is treated as having one class of ownership if all of the beneficiaries of the trust have undivided interests in all of the trust property. More than one class of ownership may exist where, for example, some beneficiaries are entitled to receive more than their pro rata share of trust distributions in early years and other beneficiaries are entitled to more than their pro rata share in later years.

Under the regulations, an arrangement having more than one class of ownership interest generally may not be treated as a trust, but is treated as a corporation. Thus, if a trust held a portfolio of mortgages, and interests in the trust assets were divided so that one class of beneficiaries were to receive all principal collected by the trust and a specified rate of interest thereon, until the trust had collected a specified amount of principal on the mortgages, and

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[10] *Id.*
[11] Treas. Reg. sec. 301.7701-2(a)(2).
[12] Treas. Reg. sec. 301.7701-4(a).
[13] Treas. Reg. sec. 301.7701-4(b).
[14] Treas. Reg. sec. 301.7701-4(c).

another class of beneficiaries were to receive all remaining amounts collected by the trust, then such trust would be treated as an association taxable as a corporation under the regulations. The regulations provide a limited exception for certain trusts with multiple classes, where the existence of multiple classes is incidental to the purpose of facilitating direct investment in the assets of the trust. The regulations apply to interests issued after April 27, 1984.

Taxation of income from debt obligations

The original issue discount rules

Treatment of original issue discount as interest

If the borrower receives less in a lending transaction than the amount to be repaid at the loan's maturity, then the difference represents "discount." Discount performs the same function as stated interest, i.e., compensation of the lender for the use of the lender's money.[15] Code sections 1272 through 1275 and section 163(e) (the "OID rules") generally require the holder of a debt instrument issued at a discount to include annually in income a portion of the original issue discount ("OID") on the instrument, and allow the issuer of such an instrument to deduct a corresponding amount, irrespective of the methods of accounting that the holder and the issuer otherwise use.[16]

Definitions

"Original issue discount" is defined as the excess of a debt instrument's "stated redemption price at maturity" over its "issue price" (provided such excess is not less than a certain de minimis amount).

"Issue price" generally is (1) in the case of a cash loan, the amount borrowed, (2) in the case of a debt instrument that is issued for property where either the debt instrument or the property is publicly traded,"[17] the fair market value of the property, or (3) if neither the debt instrument nor the property exchanged for it is publicly traded, an amount determined using an adequate interest rate.

"Stated redemption price at maturity" includes all amounts payable at maturity excluding any interest based on a fixed rate and payable unconditionally over the life of the debt instrument at fixed intervals no longer than one year.

Operation of the OID rules

The amount of the OID in a debt instrument, if any, is allocated over the life of the instrument through a series of adjustments to the issue price for each "accrual period." The accrual period gener-

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[15] *United States* v. *Midland-Ross Corp.*, 381 U.S. 54 (1965); *see also Commissioner* v. *National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134 (1974).

[16] Prior to 1982, the OID rules applied only to a limited class of obligations. The Tax Equity and Fiscal Responsibility Act of 1982 and the Tax Reform Act of 1984 greatly expanded the number and types of obligations to which the OID rules apply.

[17] Presently, only stock or securities traded on an established securities market are treated as publicly traded. However, section 1803(a)(10) of the bill would grant the Treasury Department authority to issue regulations treating as publicly traded other property "of a kind regularly traded on an established market."

ally is each six-month or shorter period ending on the calendar day corresponding to the date of the debt instrument's maturity and the date six months prior to the date of maturity.[18] The adjustment to the issue price for each accrual period is determined by multiplying the "adjusted issue price" (i.e., the issue price increased by adjustments prior to the beginning of the accrual period) by the instrument's yield to maturity, and then subtracting the interest payable during the accrual period.

The adjustment to the issue price for any accrual period is the amount of OID allocated to that accrual period. These adjustments reflect the amount of the accrued but unpaid interest on the debt instrument in each period. The holder is required to include this amount as interest income and the issuer is permitted a corresponding interest deduction. The holder's basis in the obligation is increased by the amount of OID includible in the holder's income."[19] Uncertainty exists about the application of the rules where the maturity of such payments may be accelerated (e.g., based on prepayments on home mortgages that collateralize the obligation).

Gain or loss on disposition or prepayment

In general, the sale or exchange of a debt obligation that is a capital asset results in the realization of a capital gain or loss to the seller. Under section 1271, amounts received by a holder of a debt obligation, other than one issued by an individual, on retirement of such debt obligation is treated as an amount received in exchange for the debt obligation. Thus, subject to certain exceptions discussed below, if a debt obligation not issued by an individual is a capital asset, its satisfaction, either at or in advance of its maturity, generally results in the realization of a capital gain or loss measured by the difference between the amount realized and the basis of the obligation. Since section 1271 does not apply to obligations issued by individuals, repayment of a debt obligation by an individual (including prepayment) is not treated as a sale or exchange, and thus may not give rise to capital gain or loss.[20]

Capital gain treatment also is unavailable if an obligation has original issue discount and, at the time of original issue, there was an intention to call the obligation before maturity. In general, in such a case, any gain realized on the sale or exchange (including retirement by the issuer) of the obligation is treated as ordinary income to the extent that the gain does not exceed the amount of unamortized original issue discount (sec. 1271(a)(2)). There is no au-

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[18] Under proposed regulations, different accrual periods may be required. *See* Prop. Treas. Reg. sec. 1.1272-1(d).

[19] The premise of the OID rules is that, for Federal income tax purposes, an obligation issued at a discount should be treated like an obligation issued at par requiring current payments of interest. Accordingly, the effect of the OID rules is to treat the borrower as having paid semiannually to the lender the interest accruing on the outstanding principal balance of the loan, thereby permitting the borrower to deduct as interest expense and requiring the lender to include in income such interest which has accrued but is unpaid. The lender then is deemed to have lent the accrued but unpaid interest back to the borrower, who in subsequent periods is deemed to pay interest on this amount as well as on the principal balance. This concept of accruing interest on unpaid interest is commonly referred to as the "economic accrual" of interest, or interest "compounding."

[20] *See* sec. 1271(b)(1). In addition, obligations issued before July 2, 1982, by an issuer other than a corporation or a government (or political subdivision thereof) do not qualify for capital gains treatment. *See* sec. 1271(b)(2).

thority that directly addresses the application of this provision to corporate debt obligations that are issued with original issue discount and that are called prior to maturity upon the prepayment of mortgages in a pool that collateralizes the debt obligation.

The market discount rules

The availability of capital gain treatment on the sale or exchange of a debt obligation also may be limited pursuant to the so-called "market discount" rules. In general, under the market discount rules (secs. 1276–1278), gain on the disposition of a debt obligation that was issued after July 18, 1984, generally is treated as interest income to the extent of accrued market discount. Market discount is defined as the excess of the stated redemption price of an obligation over its basis immediately after acquisition, (provided that such excess is not less than a certain *de minimis* amount). In the case of a bond that has original issue discount, for purposes of the market discount rules, its stated redemption price is treated as the sum of its issue price and the amount of original issue discount that would have been includible in the income of an original holder.

Accrued market discount on an obligation generally is the amount that bears the same ratio to the market discount on such obligation as the number of days the taxpayer holds the obligation bears to the number of days after the taxpayer acquired the obligation until its maturity (sec. 1276(b)(1)). However, the holder may elect to accrue the market discount on an obligation using a constant interest rate.[21] A holder also may elect to include accrued market discount in income annually (sec. 1278(b)). Under present law, the method of allocating market discount among principal payments on an obligation where such principal is paid in multiple installments is uncertain.

If indebtedness is incurred to purchase or carry obligations that have market discount, interest on such indebtedness in excess of the amount of interest includible in income with respect to such obligation is deductible only to the extent that such interest exceeds the market discount allocable to the taxable year (sec. 1277). Any interest expense disallowed under this provision is allowable as a deduction in the year that the obligation is disposed of. This limitation on interest deductions is not imposed if the holder elects to include market discount in income currently.

The coupon stripping rules

The separation of ownership of the right to receive any payment of principal or interest on a debt obligation generally results in the application of the "coupon stripping" rules (sec. 1286). Under these rules, the holder of a debt obligation who disposes of the right to receive certain payments on the obligation, (other than a pro rata share of all payments), must allocate, (on the basis of fair market value), his basis in the obligation between the portion of the debt obligation that is disposed of and the portion retained, for purposes of recognizing gain or loss.

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[21] The constant interest rate method results in smaller amounts being treated as accrued market discount in the earlier years.

Following such a disposition, for purposes of the treatment of the holder, the retained portion is treated as a debt obligation having original issue discount equal to the excess of the amount that will be received upon payment of amounts due at maturity of such retained portion over the amount of basis allocated thereto. Similarly, a purchaser of the disposed of portion of the debt obligation is treated as having purchased a debt obligation having original issue discount equal to the excess of the amount payable upon maturity of such portion over the amount paid therefor. The original issue discount rules then govern the amount that the respective holders must include in income annually.

Withholding on interest paid to foreign taxpayers

In general, a 30-percent withholding tax is imposed on portfolio interest paid to foreign taxpayers (secs. 871, 881, 1441, and 1442).[22] However, the withholding tax is not imposed on interest paid on certain obligations issued after July 18, 1984 (secs. 871(h) and 882(c)). Although obligations issued by individuals generally are not eligible for the exception,[23] most mortgage-backed securities issued after July, 18, 1985, are eligible for the exception.[24] This is true even if the mortgage-backed security is in the form of a participation certificate in a grantor trust, in which case, the holder is for all other purposes treated as holding a proportionate share of the underlying mortgages. In such a case, however, the withholding tax is applied to the extent that the underlying mortgages were issued on or before July 18, 1984.[25]

Reasons for Change

The committee recognizes the increasing extent to which real estate mortgages are traded on secondary markets and the increasing extent to which multiple-class arrangements are used in the "packaging" of mortgages. The committee understands that considerable uncertainty exists concerning several aspects of the Federal income tax treatment of these types of securities. Accordingly, the committee wishes to provide rules to clarify the treatment of such securities. The committee believes that the best method for doing so is to provide a new type of vehicle for the issuance of such multiple class securities, and to provide rules that are as comprehensive as possible for the taxation of all transactions relating to the use of such vehicles. The committee believes that this vehicle should be the exclusive vehicle (accompanied by exclusive tax consequences) relating to the issuance of multiple class mortgage-backed securities, and that availability of other vehicles should be limited to the extent possible.

The committee believes that there should be some relief from two levels of taxation (i.e., at the entity level and at the shareholder level) where an entity with multiple classes of interests holds only a pool of real estate mortgages and related assets, has no

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[22] A lower rate of tax may be imposed pursuant to a treaty.
[23] Temp. Treas. Reg. sec. 35a.9999-5(a) (Q & A 1).
[24] Temp. Treas. Reg. sec. 35a.9999-5(d) (Q & A 20).
[25] *Id.*

powers to vary the composition of its mortgage assets, and has other powers generally consistent with the preservation of trust status, provided that satisfactory rules are prescribed for the taxation of the multiple interests.[26]

The committee believes that the new vehicle provided by the bill, since it is intended to be the exclusive one for the issuance of multiple class securities backed by real property mortgages, should be flexible enough to accommodate most legitimate business concerns while preserving the desired certainty of income tax treatment. Accordingly, the committee believes that the provisions of the bill should apply to any multiple class entity used for packaging interests in mortgages, regardless of the legal form used, provided that the interests satisfy the specified substantive requirements.

The committee recognizes that, in order to measure income as accurately as possible, an essential feature of providing satisfactory rules for the taxation of the multiple classes of interests is the clarification of the application of the OID rules and related issues as applied to mortgages and mortgage-backed securities. Given the uncertainty created by the unknown timing of prepayments on mortgages, the committee believes that the OID rules adopted by the bill provide a reasonable approximation of the economic accrual of income, recognizing that the amount of OID accrued in a particular accrual period under the bill, may be either greater or less than an the amount that would be accrued if there were perfect advance knowledge of the timing of prepayments.

Explanation of Provisions

Overview

In general, the bill creates a new type of entity, to be known as a "Real Estate Mortgage Investment Company" or "REMIC." In general, the REMIC is an entity that holds a fixed pool of mortgages and issues multiple classes of interests in itself to investors. The bill provides rules prescribing (1) the Federal income tax treatment of the REMIC, (2) the treatment of taxpayers who exchange mortgages for interests in the REMIC, (3) the treatment of taxpayers holding interests in the REMIC, and (4) the treatment of disposition of interests in the REMIC. The bill also clarifies the application of the OID rules to certain obligations the timing of whose maturities is contingent upon the timing of payments on the uderlying collateral. In addition, the bill imposes certain new information reporting requirements.

Further, the bill treats as a corporation any entity, referred to as an "owners' debt pool," that is used primarily to hold mortgages and issue its own debt instruments in varying maturities.

Requirements for qualification as a REMIC

Under the bill, an entity that meets certain specified requirements would be permitted to elect to be treated as a REMIC. Any entity that is treated as a corporation, association, trust, or part-

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[26] In absence of the provision of adequate rules for the taxation of the various interests, the committee believes that the treatment of multiple class trusts provided by Treas. Reg. sec. 301.7701-4(c) is an appropriate treatment of such entities.

nership may qualify as a REMIC, provided that it satisfies the specified requirements and elects REMIC status for its first and all subsequent taxable years. To elect REMIC status, the entity must satisfy requirements relating to the composition of its assets, the nature of the interests of the investors in the entity, and the distribution of the entity's cash flow.

The asset test

Under the bill, in order to qualify as a REMIC, substantially all of the assets of the entity must consist of "qualified mortgages," and "permitted investments." The committee intends that the term substantially all should be interpreted to allow the REMIC to hold only de minimis amounts of other assets.

A "qualified mortgage" is any obligation (including any participation or certificate of beneficial ownership interest therein) that is transferred to the entity on the first day that any property (a) is transferred to the entity (not including any de minimis amounts of property received on the formation of the entity, such as a corporate seal), and that (b) is principally secured directly or indirectly by an interest in real property. A qualified mortgage also includes a "regular interest" in a REMIC and a "qualified replacement mortgage." A qualified replacement mortgage is any property that would have been treated as as a qualified mortgage if it were transferred to the REMIC at the time that the REMIC received property that was treated as qualified mortgages, and that is received in exchange for a defective qualified mortgage within a two-year period beginning at the time that the entity received its other qualified mortgages.

"Permitted investments" are "cash flow investments," "qualified reserve assets," and "foreclosure property."

"Cash flow investments" are cash, cash items, and government securities (within the meaning of section 856(c)(5)), provided that the maturity date (if any) of any such asset is not later than the close of the year. In general, these are assets that are received periodically by the REMIC, invested temporarily, and paid out to the investors at the next succeeding regular payment date."

"Qualified reserve assets" are cash, cash items, and government securities (within the meaning of section 856(c)(5) that are held in a "qualfied reserve fund." A qualified reserve fund is any reasonably required reserve that is held by the REMIC to provide additional security for the payments due on regular interests in the REMIC that otherwise may be delayed or defaulted upon because of defaults (including late payments) on the qualified mortgages. In determining whether the amount of the reserve is reasonable, the committee believes that it is appropriate to take into account the creditworthiness of the qualified mortgages and the extent and nature of any guarantees relating to the qualified mortgages. The committee anticipates that amounts in the reserve fund would be reduced appropriately as regular interests in the REMIC are retired.

"Foreclosure property" is property that would be foreclosure property under section 856(e) if acquired by a real estate investment trust, and which is acquired in connection with the default or imminent default of a qualified mortgage. Property so acquired

ceases to be foreclosure property one year after its acquisition by the REMIC.

Investors' interests

In order to qualify as a REMIC under the bill, all of the interests in the REMIC must be either "regular interests" or "residual interests."

A regular interest is an interest in the entity, the terms of which are fixed upon its issuance, which terms unconditionally entitle the holder to receive a specified amount of money, the timing of which may be contingent on the extent of prepayments on qualified mortgages, and that provides for interest payments, if any, that are payable at a fixed rate on a periodic basis on the outstanding balance. Under the bill, the Treasury Department is given authority to issue regulations that may permit the use of, and prescribe the treatment of, regular interests the interest payments on which may be at variable rates. Any regular interest in a REMIC is treated, under the bill, as a debt instrument for Federal income tax purposes without regard to whether the interest otherwise would fail to be treated as a debt instrument for Federal income tax purposes.

A residual interest is an interest in the entity, the terms of which are fixed upon its issuance, which terms entitle the holder to one or more payments that are wholly contingent on the extent of prepayments on qualified mortgages, the extent of income from permitted investments, or contingent payments (such as "equity kickers") on qualified mortgages, or the return of amounts in the reserve fund. Payments (other than those with respect to the reserve fund) are not wholly contingent if the residual is guaranteed to receive any amount. The committee intends that the possibility of defaults on the qualified mortgages be disregarded for this purpose,[27] except with respect to the return of amounts in the reserve fund. The residual is not treated as being guaranteed to receive any amount (other than with respect to the reserve fund assets, and disregarding the possibility of defaults on the qualified mortgages) only if the possibility exists, however remote, that the residual interest could receive no payments if a specified pattern of prepayments on the qualified mortgages occurs, and no contingent payments on the qualified mortgages are received.

Distribution requirement

To qualify as a REMIC, the entity is required to distribute 100 percent of its net cash flow within 15 days of the end of each taxable year. The entity's net cash flow is the excess of the (a) the sum of the amount of cash received from (i) payments of principal and interest on the qualified mortgages, (ii) earnings on reserve fund assets and permitted investments, (iii) reductions in the amount reasonably required in the reserve fund, and (iv) net cash flow from foreclosure property (including any net income from foreclosure property and the proceeds of any sale of foreclosure property), over (b) the sum of (i) amounts paid representing principal and interest on regular interests, (ii) distributions to the holders of residual in-

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[27] *Cf.* Prop. Treas. Reg. sec. 1.1275-4(b)(1).

terests, (iii) amounts reasonably required to replace amounts disbursed from the reserve fund, (iv) taxes paid, and (v) operating expenses incurred.

Transfers of property to the REMIC

The committee believes that regular and residual interests in a REMIC differ materially (within the meaning of Treas. Reg. sec. 1.1001–1(a)) from the qualified mortgages and other assets held by the REMIC. Accordingly, the bill requires the recognition of gain by the transferor upon the transfer to the REMIC of qualified mortgages or other property in exchange for regular or residual interests in the REMIC. The amount of gain to be recognized on the exchange is determined by reference to the fair market value of the interests received.

Notwithstanding that regular and residual interests in a REMIC are fundamentally different from the REMIC's assets, the committee believes that an owner of mortgages should not be able to recognize losses merely by contributing the mortgages to a REMIC and receiving in return regular and residual interests. Thus, the bill defers the recognition of loss on the transfer of property to a REMIC in exchange for interests in the REMIC.

The REMIC's basis in the property received is equal to the fair market value of the property at the time of the transfer, whether or not the transferor realized any gain or loss.

Taxation of the REMIC

Issuance of regular or residual interests

No gain or loss is recognized to the REMIC on the exchange of regular or residual interest in the REMIC for property.

Taxable year; rate of tax; method of accounting

The REMIC is required to adopt a calendar year as its taxable year. The REMIC is required to compute and pay tax at the highest corporate rate on its "REMIC income" in each taxable year. In addition, the REMIC is required to pay a 100 percent tax on its net income from prohibited transactions. The REMIC is required to adopt the accrual method of accounting.

"REMIC income"

REMIC income generally is equal to the taxable income of the REMIC with certain adjustments. The adjustments include (i) an unlimited carryback of net operating losses of the REMIC, (ii) a deduction for certain amounts paid to holders of residual interests, (iii) disallowance of the dividends received deduction for corporations, and (iv) exclusion of all items of income, gain, loss, or deduction relating to prohibited transactions. For purposes of imposing the 100 percent tax on prohibited transactions, net income from prohibited transactions is computed without taking into account any losses from prohibited transactions or deductions relating to prohibited transactions resulting in a loss. The REMIC is required to amortize its organizational expenses (under section 248) over the period of the mortgage held by the REMIC with the longest maturity.

The REMIC is required to elect under section 1278(b) to include currently in income any market discount income on its qualified mortgages.

Deductions for certain amounts paid to residual interests

Under the bill, in computing its REMIC income for a taxable year, the REMIC is given a deduction for amounts distributed to holders of residual interests up to the amount by which the aggregate amount of all of the "daily accruals" on all residual interests in the REMIC for all periods before the close of the taxable year exceeds amounts distributed to holders of residual interests for which a deduction was allowed in prior taxable years.

The daily accrual for any residual interest for any day in any accrual period is the ratable portion of the product of the adjusted issue price of the residual interest at the beginning of such accrual period, and the long-term Federal rate.[28] The long term Federal rate used for this purpose is the Federal long term rate that would have applied to the residual interest under section 1274(d) (without regard to section 1274(d)(2)) if it were a debt instrument. The rate is adjusted appropriately for the length of the accrual period, and is applied on the basis of compounding at the end of each accrual period.

Prohibited transactions

Prohibited transactions for the REMIC include the disposition of any qualified mortgage other than pursuant to (i) the substitution during the two-year period beginning at the time that qualified mortgages are first transferred to the REMIC, of a qualified replacement mortgage for a defective [29] qualified mortgage, (ii) the bankruptcy or insolvency of the REMIC, (iii) a disposition incident to the foreclosure, default, or imminent default of the mortgage, or (iv) a qualified liquidation (described below). Other prohibited transactions include the disposition of any cash flow investment other than pursuant to a qualified liquidation, the receipt of any income from assets other than assets permitted to be held by the REMIC, and the receipt of any compensation for services.

Taxation of the holders of regular interests

Treatment of regular interests as debt instruments

Under the bill, regular interests are treated as debt instruments for Federal income tax purposes. Holders of regular interests generally are taxed as if their regular interest were a debt obligation to which the rules of taxation generally applicable to debt obligations apply, except that the holder of a regular interest is required to account for income relating to such interest on the accrual method of accounting regardless of the method of accounting otherwise used by the holder.[30] In the case of regular interests that are

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[28] The rules for determining the adjusted issue price and accrual period for residual interests are discussed below.

[29] explanation of what defective means

[30] The committee intends that periodic payments of interest are to be treated as accruing pro rata between the dates that such interest is paid.

issued in a form other than debt, the amount of the fixed unconditional payment is treated as the stated principal amount of the debt instrument, and the periodic payments (i.e., the amounts that are based on the amount of the fixed unconditional payment), if any, are treated as stated interest payments.

Since the regular interests are treated as debt instruments, the REMIC is subject to the reporting requirements of section 1275 with respect to the regular interests. In addition, regular interests are treated as evidences of indebtedness under section 582(c)(1), gain or loss from the sale or exchange of which by certain financial institutions would not be treated as the sale or exchange of a capital asset. Moreover, if the REMIC is a corporation or is treated as a corporation because it qualifies as an owners' debt pool, any market premium on a regular interest could be amortized currently under section 171.

Regular interests in the REMIC are treated as having an issue price equal to the fair market value of the interest at the time of its issuance. In the case of regular interests that are sold for cash or that are publicly offered, however, the rules of sections 1273(b)(1) and (2) apply in determining the issue price. A holder's basis in the regular interest generally is equal to the holder's cost therefor, but in the case of holders who received their interests in exchange for property, then the holder's basis is equal to the basis of the property exchanged for the REMIC interest plus any gain recognized. Where property is transferred in exchange for more than one class of regular or residual interest, the basis of the property transferred is allocated in accordance with the fair market value of the interests received.

OID and market discount rules

The bill provides rules clarifying the application of the OID rules to debt instruments that, as is generally the case with regular interests, have a maturity that is initially fixed, but that is accelerated based on prepayments on other debt obligations securing the debt instrument. In general, the clarified OID rules require OID for an accrual period to be calculated and included in the holder's income based on the increase in the present value of remaining payments on the debt instrument, taking into account payments includible in the instrument's stated redemption price at maturity, received on the regular interest during the period. For this purpose, the present value calculation is made at the beginning of each accrual period (a) using the yield to maturity determined for the instrument at the time of its issuance, calculated on the assumption that no prepayments would occur, and (b) assuming that no prepayments (other than those already made) would be made as of each time that the present value calculation is made.

The bill grants authority to the Treasury Department to issue regulations relating to the treatment of market discount on debt instruments the principal of which is paid in installments, and debt instruments the maturity of which is affected by prepayments on other debt instruments. Until such time that the Treasury Department issues such regulations, the committee intends that, in the case of regular interests that have OID, that market discount shall be deemed to accrue in proportion to the accrual of OID for

any accrual period, and in the case of regular interests that have no OID, the amount of market discount that is deemed to accrue is the amount of discount that bears the same ratio to the total amount of remaining market discount on the instrument that the amount of stated interest paid in the accrual period bears to the total amount of interest that would be paid as of the beginning of the accrual period, assuming that no prepayments (other than those that occurred prior to the beginning of the accrual period) on the instrument will occur. A holder of a regular interest shall recognize accrued market discount upon the receipt of payments includible in the instrument's stated redemption price at maturity to the extent of the payments. The committee intends that the same rules that apply for the accrual of market discount should be applied in amortizing amortizable bond premium (within the meaning of sec. 171).

Disposition of regular interests

Because of the high degree of certainty that some prepayments on qualified mortgages will occur, the committee believes that regular interests in a REMIC properly are treated as debt instruments for which there is an intention to call before maturity. Accordingly, the bill treats gain on the disposition of a regular interest as ordinary income to the extent of unaccrued OID. The committee intends no inference regarding the treatment of debt instruments that are not regular interests in a REMIC.

Taxation of the holders of residual interests

Under the bill, holders of residual interests generally are, treated as holders of stock in a corporation. Distributions on residual interests are not eligible for any dividends received deduction, however, and to the extent inconsistent with treatment as stock, the Federal income tax treatment of holders of residual interests are determined under the provisions of the bill. The residual interest is treated as having an "issue price," which is equal to the amount of money paid for the interest at the time it is issued, or the fair market value of the interest at the time it is issued.[31] The issue price of the residual interest is adjusted as described below.

Distributions from the REMIC to the holders of residual interests are treated as dividends that are includible in the income of the holder to the extent that the amount distributed does not exceed the excess (if any) of the sum of the daily accruals with respect to such interest for the period that the holder held the interest, over amounts previously included in the the gross income of the holder with respect to such interest.

Distributions from the REMIC to a residual holder in excess of the amount that the holder is required to include as income are first applied against and reduce the adjusted basis (and adjusted issue price) of the interest, and then are treated as gain from the sale or exchange of the residual interest. Any amount realized on the disposition of any residual interest is included as ordinary income by the holder disposing of the residual interest, to the

[31] Under section 1275, the REMIC is required to determine and report the issue price of the residual interest.

extent that the amount of any distribution by the REMIC would be includible as dividend income to the holder disposing of the interest. The adjusted basis of the residual is increased by the amount so includible in income. The Treasury Department is granted authority to issue regulations applying rules similar to those under section 1276(a)(2), 1276(a)(3), 1276(c), and 1276(d) to the disposition of residual interests. The committee expects that the Treasury Department will issue regulations prescribing the appropriate treatment of residual holders whose basis in the residual interest is either greater or less than the adjusted issue price of the residual interest.

Liquidation of the REMIC

Under the bill, if a REMIC adopts a plan of complete liquidation, and sells all of its assets (other than cash) within the 90-day period beginning on the date of the adoption of the plan of liquidation, then the REMIC recognizes no gain or loss on the sale of its assets, provided that the REMIC distributes in liquidation all of sale proceeds plus its cash (other than amounts retained to meet claims) to holders of regular and residual interests within the 90-day period.

Other provisions

Compliance provisions

The application of the OID and market discount and premium rules contemplated by the bill require calculations that are based on information that would not necessarily be known by any holder, and is more readily available to the REMIC than any other person. Thus, the bill requires broader reporting of interest payments and OID accrual by the REMIC, or any other entity that issues debt that is subject to the OID rules of the bill. The bill specifies that the amounts treated as interest on regular REMIC interests are treated as interest for purposes of the reporting requirements of the Code (sec. 6049) and that the REMIC or similar issuer is required to report interest and OID to a broader group of holders than is required under present law. The holders to whom such broader reporting is required include corporations, certain dealers in commodities or securities, real estate investment trusts, common trust funds, and certain other trusts. In addition to reporting interest and OID, the REMIC or similar issuer is required to report sufficient information to allow holders to compute the accrual of any market discount or amortization of any premium in accordance with the methods intended by the committee.[32] The REMIC also is required to report to holders of residual interest the aggregate amount of daily accruals for each accrual period.

Treatment of REMIC interests for financial institutions and real estate investment trusts

Under the bill, regular and residual interests are treated as qualifying real property loans for purposes of section 593(d)(1). In

[32] If Treasury regulations prescribe an alternative method for the accrual of market discount or the amortization of premium, the committee intends that such regulations also may require reporting of adequate information to implement such alternative method.

the case of residual interests, the committee intends that the amount treated as a qualifying real property loan not exceed the basis of the residual. Both regular and residual interests are treated as real estate assets under section 856(c)(6) for purposes of determining eligibility for REIT status. In the case of a residual interest, the fair market value of the residual interest and not the fair market value of all of the REMIC's assets is used in applying the asset test of section 856(c)(5).

Foreign withholding

The committee intends that regular interests in REMICs should receive the same treatment as mortgage pass-through securities for purposes of applying the rules relating to withholding on interest paid to foreign persons. Amounts distributed to foreign persons with respect to residual interests are subject to withholding at the statutory rate to the extent that such amounts are treated as dividends.

Owners' debt pools

The committee intends that REMICs are to be the exclusive means of issuing multiple class real estate mortgage backed securities without the imposition of two levels of taxation. Thus, under the bill, any entity that otherwise would be treated as a partnership or trust for income tax purposes is treated as a corporation if the principal activity of the trust or partnership is holding assets a substantial portion of which are real property mortgages that directly or indirectly act as collateral for other debt obligations having varying maturities.[33]

This provision is intended to apply to any arrangement under which mortgages are segregated from a debtor's business activities for the benefit of creditors whose loans are of varying maturities. For example, REMICs generally would be treated as owners' debt pools and hence as corporations under this provision.[34] In addition, certain arrangements that are commonly known as "Owners' Trusts" would be treated as corporations under the bill.

Effective Date

The provisions of the bill are effective with respect to taxable years beginning after December 31, 1986. The amendments made by the bill to the OID rules apply to debt instruments issued after December 31, 1986. The provisions relating to owners' debt pools do not apply to any entity in existence on December 31, 1986, unless there is a substantial transfer of cash or property to such entity after such date.

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[33] For this purpose, the committee intends that debt instruments that may have the same stated maturity but different rights relating to acceleration of that maturity, are to be treated as having different maturities.

[34] As discussed above, to qualify as a REMIC, an entity would meet all the requirements to qualify as an owners' debt pool, except for the requirement relating to the issuance of debt that has varying maturities. Where a REMIC does issue debt of varying maturities, however, it would necessarily meet the requirements to be treated as an owners' debt pool.

Revenue Effect

The provision is expected to decrease fiscal year budget receipts by $2 million in 1987, $5 million in 1988, $5 million in 1989, $6 million in 1990, and $6 million in 1991.

G. Interest Deduction Limitations (sec. 1421 of the bill and secs. 163 (d) and (h) of the Code)

Present Law

In general

Under present law (Code sec. 163(d)), in the case of a noncorporate taxpayer, deductions for interest on indebtedness incurred or continued to purchase or carry property held for investment are generally limited to $10,000 per year, plus the taxpayer's net investment income. Investment interest paid or accrued during the year which exceeds this limitation is not permanently disallowed, but is subject to an unlimited carryover and may be deducted in future years (subject to the applicable limitation) (sec. 163(d)(2)). Interest incurred to purchase or carry certain property that is subject to a net lease generally is treated as investment interest, if certain trade or business deductions are less than 15 percent of the rental income, or if the lessor is guaranteed a specific return or is guaranteed against loss of income.

Income and interest of partnerships and S corporations generally retain their entity level character (as either investment or non-investment interest or income) in the hands of the partners and shareholders. The present-law treatment of interest incurred to purchase or carry a partnership interest or S corporation stock is not entirely clear.[1]

Investment income and expenses

Investment income.—Investment income under present law is income from interest, dividends, rents, royalties, short-term capital gains arising from the disposition of investment assets, and any amount of gain treated as ordinary income pursuant to the depreciation recapture provisions (secs. 1245, 1250, and 1254), but only if the income is not derived from the conduct of a trade or business (sec. 163(d)(3)(A)).

Investment expenses.—In determining net investment income, the investment expenses taken into account are trade or business expenses, real and personal property taxes, bad debts, depreciation, amortizable bond premiums, expenses for the production of income, and depletion, to the extent these expenses are directly connected with the production of investment income.

For purposes of this determination, depreciation with respect to any property is taken into account on a straight-line basis over the

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[1] Proposed Treas. Reg. sec. 1.57-2(b)(2)(i) implies that the interest would not be investment interest where the underlying assets are not investment assets. Compare Rev. Proc. 72-18, 1972-1 C.B. 740, sec. 4.05 (relating to sec. 265 of the Code), and sec. 163(d)(7); see H.R. Rep. No. 97-760, 97th Cong., 2d Sess. at 476-477 (1982).

useful life of the property, and depletion is taken into account on a cost basis.

Other interest

Under present law, no limitation is imposed under section 163(d) on the deductibility of interest on indebtedness incurred for other purposes, e.g. to purchase or carry consumption goods. Interest on indebtedness incurred in connection with the taxpayer's trade or business is also not subject to the section 163(d) limitation under present law.

Reasons for Change

Investment interest

Under present law, leveraged investment property is subject to an interest limitation, for the purpose of preventing taxpayers from sheltering or reducing tax on other, non-investment income by means of the unrelated interest deduction. The committee believes that the interest limitation should be strengthened so as to reduce the mismeasurement of income which can result from the deduction of investment interest expense in excess of current investment income, and from deduction of current investment expenses with respect to investment property on which appreciation has not been recognized.

In addition, the committee recognizes that the status of a passive investor in a limited partnership or an S corporation is more like that of a taxpayer holding corporate stock than that of a taxpayer actively conducting a trade or business, because of the investor's lack of material participation. Limited partnership interests, for example, are generally treated as "securities" for purposes of Federal and State securities laws.

The committee finds it appropriate to treat such interests in enterprises in whose activities the taxpayer does not materially participate as investment property. To the extent that the dividing line between an investment activity and a business activity depends upon the status of the taxpayer as a participant in the underlying trade or business, an interest in a business activity in which the taxpayer does not materially participate (or actively participate, in the case of rental real estate activities) should also should be treated as investment property for this purpose. Accordingly, interest deductions relating to such investment property are subject to the limitation on the deductibility of investment interest under the bill.

Under present law, the computation of net investment income measures depreciation using straight-line depreciation over the useful life of the property. Thus, any reduction in taxable investment income attributable to incentive depreciation deductions is allowable in full without reducing net investment income and, accordingly, without reducing the amount of investment interest currently deductible. The effect of the provision is that availability of tax shelters may not be sufficiently restrained under present law since passive investors are able to take advantage of both the deductibility of interest in full plus the full depreciation deductions,

which together may provide substantial mismeasurement of income.

Under present law, leased property is treated as investment property if certain out-of-pocket trade or business deductions attributable to the property are less than 15 percent of the rental income from the property. If, in an effort to reduce out-of-pocket costs, an owner of rental property performs management and repair services, the costs deductible as trade or business expenses may be reduced below 15 percent of rental income, even though the taxpayer may be actively managing the property. The problem may be particularly acute for taxpayers who have relatively small amounts of rental property. In such circumstances, the committee believes, it would be appropriate to permit the taxpayer to include the value of his personal management and repair services along with actual out-of-pocket expenses for purposes of the 15 percent test.

Nonbusiness (consumer) interest

Present law excludes or mismeasures income arising from the ownership of housing and other consumer durables. Investment in such goods allows consumers to avoid the tax that would apply if funds were invested in assets producing taxable income and to avoid the cost of renting these items, a cost which would not be deductible in computing tax liability. Thus, the tax system provides an incentive to invest in consumer durables rather than assets which produce taxable income and, therefore, an incentive to consume rather than save.

Although the committee believes that it would not be advisable to subject to income tax imputed rental income with respect to consumer durables owned by the taxpayer, it does believe that it is appropriate and practical to address situations where consumer expenditures are financed by borrowing. By phasing out the present deductibility of consumer interest, the committee believes that it has eliminated from the present tax law a significant disincentive to saving.

While the committee recognizes that the imputed rental value of owner-occupied housing may be a significant source of untaxed income, the committee nevertheless believes that encouraging home ownership is an important policy goal, achieved in part by providing a deduction for residential mortgage interest. Therefore, the interest limit does not affect the deductibility of interest on debt secured by the taxpayer's principal residence or on a second home, to the extent of the fair market value of the principal residence (or second home).

Explanation of Provisions

In general

The bill expands the scope of the interest limitation, and alters the calculation of the amount of the limitation. Under the bill, all nonbusiness interest is subject to the limitation on deductibility, including consumer interest and certain interest that is not treated as investment interest subject to limitation under present law. Interest subject to the limitation under the bill does not include interest on debt secured by the taxpayer's principal residence (to the

extent of its fair market value), and interest on debt secured by a second residence of the taxpayer (to the extent of its fair market value). Interest expense that is paid or incurred in carrying on a trade or business is not subject to the interest deduction limitation under the bill (except for interest attributable to certain limited business interests).

In general, under the bill, consumer interest is not deductible, and the deduction for investment interest is limited to investment income for the year with an indefinite carryforward of disallowed investment interest.

Investment interest limitation

Interest subject to the limitation.—Under the bill, interest subject to the investment interest limitation is all interest (other than consumer interest and qualified residence interest) on debt not incurred in connection with the taxpayer's trade or business. Thus, interest subject to limitation generally includes investment interest subject to the section 163(d) limitation under present law and interest expense attributable to a limited business interest, including interest paid or incurred on debt of the activity in which the taxpayer has a limited business interest and interest paid or incurred to purchase or carry a limited business interest.[2] A limited business interest includes an interest as a limited partner in a partnership, except as provided in regulations. It is anticipated that such regulations will provide that, in certain circumstances, limited partnership interests will not be treated as limited business interests. It is intended that this grant of authority be used to prevent taxpayers from manipulating the rule that limited partnership interests are treated as limited business interests, in attempting to evade the interest limitation provisions. Also treated as a limited business interest is an interest as a shareholder of an S corporation in whose activities the taxpayer does not materially participate, an interest as lessor in a net lease, as well as an interest in any activity in which the taxpayer does not materially participate (or, in the case of rental real estate activities, actively participate)[3] and the income or loss from which is trade or business income or loss.[4]

Net investment income.—Under the bill, the definition of investment income is expanded to include the taxpayer's share of income or loss (without regard to interest expense) attributable to any limited business interest (e.g., a limited partnership interest, stock of an S corporation in which the taxpayer does not materially participate, an interest as lessor in a net lease, or any interest in a trade or business activities in which the taxpayer does not materially participate). It also includes the gain on investment property. Net

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[2] As under present law, interest on indebtedness incurred to purchase into a trade or business partnership as a general partner (which partnership interest is not a limited business interest) is not treated as investment interest for purposes of section 163(d)). See, e.g., Technical Advice Memorandum 8235004 (May 21, 1982).

[3] Material participation in an activity has the same meaning, for purposes of the investment interest limitation, as it has for purposes of the passive loss rule (sec. 1401 of the bill and sec. 469 of the Code), except that there is no special rule for rental activities. Similarly, active participation, in the case of rental real estate activities, has the same meaning as under that section.

[4] E.g., a grantor of a grantor trust or an investor in a proprietorship in some circumstances.

investment income is increased by certain out-of-pocket expenses attributable to net leased property, as under present law.

As under present law, net investment income is the excess of investment income over investment expense. Under the bill, investment expense is determined utilizing the actual depreciation or depletion deductions allowable.

Net leases.—The bill modifies the 15-percent test of present law, which determines whether leased property is subject to a net lease, and therefore constitutes a limited business interest in the hands of the lessor. Under the bill, in determining whether certain expenses constituting trade or business deductions are less than 15 percent of the rental income from the leased property, the value of the personal management and repair services performed with respect to the leased property by an individual taxpayer who is a direct owner of the property may be counted. Management and repair services of a general partner in a general partnership that directly owns the leased property may also be counted. In the case of services by the general partners, to qualify for this rule, the property must be managed exclusively by such general partners, with no substantial payments to third parties for management services (other than for accounting and tax preparation services and repairs). The value of legal services may not be counted.

Consumer interest limitation

Under the bill, consumer interest is not deductible. Consumer interest generally includes all interest not incurred or continued in connection with the conduct of a trade or business (other than the performance of services as an employee) or in connection with an activity described in section 212, relating to expenses for the production of income.[5] Interest on debt secured by the taxpayer's principal residence and a second residence remains deductible as under present law. Thus, consumer interest includes, for example, interest on a loan to purchase an automobile for personal use, and credit card interest incurred for personal expenses.

Residences of the taxpayer.—Interest on debt secured by a security interest perfected under local law on the taxpayer's principal residence or a second residence of the taxpayer is not treated as consumer interest subject to the limitation under the bill. The taxpayer's principal residence is intended to be the residence that would qualify for rollover of gain under section 1034 if it were sold. A principal residence may be a condominium or cooperative unit.[6] A dwelling unit will qualify as a residence only if it meets the requirements for use as a residence under section 280A. The fact that state homestead laws may restrict the rights of secured parties with respect to certain types of residential mortgages will not cause the interest paid under such mortgages to be treated as nondeductible consumer interest, provided the lender's security interest is perfected and provided the interest on the debt is otherwise qualified residence interest.

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[5] Thus, for example, interest on debt to finance an employee business expense is not deductible, under this rule.

[6] A principal residence may also include a houseboat or house trailer. See Treas. Reg. sec. 1.1034-1(c)(3).

A second residence of the taxpayer includes a residence used by the taxpayer as a dwelling unit during any part of the year (gain on which could qualify for rollover treatment under section 1034 if the residence were used as a principal residence). In the case of a joint return, it includes a residence used by the taxpayer or his spouse and which is owned by either or both spouses.

Interest not treated as consumer interest under the provision includes interest on debt secured by the taxpayer's stock in a housing cooperative unit that is a residence of the taxpayer, or by his proprietary lease with respect to the unit, to the extent such debt, in the aggregate, does not exceed the fair market value of the cooperative unit. In addition, interest not treated as consumer interest under the provision includes the taxpayer's share under section 216 of interest expense of the housing cooperative allocable to his unit and to his share of common residential (but not commercial) areas of the cooperative.

In the case of a husband and wife filing separate returns, each spouse may deduct interest on debt secured by one residence. Alternatively the spouses may consent in writing to allow one spouse to claim interest on debt secured by two residences at least one of which is a principal residence. In the latter case, any interest of the other spouse on debt secured by a residence is treated as interest which may be subject to disallowance.

In the case of a taxpayer who owns more than two residences, the taxpayer may designate each year which residence (other than the taxpayer's principal residence) the taxpayer wishes to have treated as the second residence, the interest relating to which is not subject to limitation under the provision.

Rental use

Under the bill, if property is used partly for rental purposes and partly for personal purposes (such as a vacation home used by the taxpayer as a residence and also rented out for part of the year), the interest on debt attributable to such property is first allocated to the rental use and the personal use under allocation rules similar to section 280A(e)(1) of present law. Interest is allocated to the rental use (rather than residential use) in the ratio of the number of days the property is rented at fair rental to the number of days the property is used during the taxable year.

In the case of qualified residence interest, the effect of present law is continued, so that all qualified residence interest on first and second homes continues to be deductible. In the case of interest other than qualified residence interest, the interest allocated to the rental use will be allowed to the extent it does not exceed gross income (net of taxes and other deductions which would be allowed whether or not the property was used as rental property). Any interest allocable to the rental use in excess of such amount will then be treated as investment interest and will be allowed to the extent section 163(d) does not disallow the interest.

Effective Date

The interest limitation, as amended by the bill, is effective for interest paid or incurred in taxable years beginning on or after Janu-

ary 1, 1987, regardless of when the obligation was incurred, but is phased in over a 5-year period. The amount of interest disallowed during any year in the transitional period cannot exceed the amount which would be disallowed for that year under present law plus the applicable percentage of any additional interest which would be disallowed for that year under the new provision, if fully effective. The applicable percentage is 35 percent in 1987, 60 percent in 1988, 80 percent in 1989, 90 percent in 1990 and 100 percent in 1991 and thereafter. The consumer interest limitation and the investment interest limitation are each phased in separately at the same rate.

Thus, for example, under both the consumer and the investment interest limitation, in 1987 the taxpayer would calculate (1) the amount of the interest disallowed for the year under the pre-1987 rule (which in the case of consumer interest is zero), and then (2) the amount of interest disallowed for the year (as if fully phased in) under the post-1986 rule (as if fully phased in). Interest disallowed for 1987 would not exceed the amount calculated under (1), plus 35 percent of the amount by which (2) exceeds (1). If in any year, the amount of the interest disallowed under the new limitation (if fully phased in) would be less than the amount subject to the old limitation, the interest disallowed will be the amount determined as if the new rule were fully effective in that year. Thus, the taxpayer receives the benefit of the new rule in any year when it would give him a greater interest deduction than would the old rule.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $723 million in 1987, $5,059 million in 1988, $6,616 million in 1989, $7,780 million in 1990, and $8,014 million in 1991.

TITLE XV—TAX-EXEMPT BONDS

A. Tax-Exempt Bond Provisions (secs. 1501 through 1516 and 1518 of the bill, and secs. 25, 103, 103A and 6652 of the Code)

Present Law

Overview

Interest on obligations issued by States, territories and possessions of the United States, and the District of Columbia generally is exempt from Federal income tax (Code sec. 103).[1] Similarly, interest on obligations of political subdivisions of these governmental entities generally is tax-exempt.[2]

In determining whether interest on a particular obligation of a qualified governmental unit is tax-exempt, a three-part inquiry is made. First, the activity being financed, and thereby the type of bond being issued, must be determined. (The type of bond is determined by the use of the bond proceeds.) Second, the authority of the issuer to issue the tax-exempt debt must be established. Finally, compliance with Internal Revenue Code rules governing tax-exempt bonds for the activity being financed must be established.

Under these rules, qualified governmental units may finance governmental projects or services, including facilities such as schools, roads, and water and sewer facilities. Additionally, qualified governmental units may provide tax-exempt financing for use by charitable, religious, scientific, or educational organizations (section 501(c)(3) organizations) and for certain activities of other nongovernmental persons (by means of certain industrial development bonds, student loan bonds, and mortgage revenue bonds). Interest on financings for activities of nongovernmental persons is taxable unless an exception is provided in the Internal Revenue Code for the specific type of financing.

Tax-exempt bonds generally

Bonds to finance activities of governmental units

Qualified governmental units may issue tax-exempt bonds to finance general government operations[3] and facilities without regard to most of the restrictions (including volume limitations) that apply to bonds used to finance activities of nongovernmental

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[1] In certain cases, these bonds may be issued on behalf of States or local governments. (See, e.g., Rev. Rul. 63-20, 1963-2 C.B. 397 and Rev. Proc. 82-26, 1982-1 C.B. 476. References to bonds issued by States or local governments herein generally include such bonds issued on behalf of those governmental units under the rules established in these Treasury Department rulings.

[2] Governments of States, U.S. possessions and the District of Columbia, and their political subdivisions, are hereinafter referred to collectively as qualified governmental units.

[3] Under these rules, for example, qualified governmental units may issue notes in anticipation of tax or other revenues (so-called tax anticipation or revenue anticipation notes (TANs or RANs)).

persons. In general, present law treats bonds for the benefit of section 501(c)(3) organizations in the same manner as bonds used to finance general government operations.

In addition to issuing bonds as evidence of indebtedness, qualified governmental units may undertake debt, the interest on which is tax-exempt, by means of installment sales contracts, mortgages, or finance leases. For example, a qualified governmental unit may purchase road construction equipment pursuant to a lease purchase agreement or an ordinary written agreement of purchase and sale. Interest paid on such acquisitions is tax-exempt if the amounts are true interest (as opposed to other payments labeled as interest). (*See, e.g.*, sec. 1273, Rev. Rul. 60–179, 1960–1 C.B. 37, and Rev. Rul. 72–399, 1972–2 C.B. 73.) These other types of financings must satisfy the same Code requirements as if a bond actually were issued. Interest paid by qualified governmental units other than pursuant to exercise of their borrowing power (e.g., interest on tax refunds) is not tax-exempt.

Present law does not contain a direct definition of when bond proceeds are used in activities of governmental units. Rather, bonds are treated as governmental, and the interest thereon is tax-exempt, unless a prescribed amount of the bond proceeds is used for activities of nonexempt persons (i.e., persons other than qualified governmental units and section 501(c)(3) organizations).[4]

Use of bond proceeds in certain trades or businesses

The first case in which bonds issued by qualified governmental units are treated as nongovernmental (causing the interest thereon to be taxable) is when the bonds are industrial development bonds (IDBs). IDBs are obligations issued as part of an issue (1) all or a major portion of the proceeds[5] of which is to be used (directly or indirectly) in a trade or business carried on by a person other than a governmental unit or a section 501(c)(3) organization (the "use" test), and (2) the payment of a major portion of the principal of, or interest on which, is derived from, or secured by, money or property used in such a trade or business (the "security interest" test) (sec. 103(b)). The security interest test is satisfied where payments are formally pledged as security for payment of the bonds and also where any underlying arrangement provides for such payments. (*See, e.g.*, Rev. Proc. 83–12, 1983–1 C.B. 674.) and Rev. Rul. 85–120, 1985–2 C.B. 4.)

Interest on IDBs is taxable unless the bonds are issued to finance certain specified exempt activities, are used for development of industrial parks, or are exempt small issues.

Use of bond proceeds to make certain loans

The second case in which obligations of qualified governmental units are treated as nongovernmental is when the bonds violate a private loan bond restriction.[6] Private loan bonds are obligations

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[4] The United States (including its agencies and instrumentalities) and all persons other than States or local governmental units (except organizations described in sec. 501(c)(3)) are nonexempt persons under these rules.

[5] Regulations define a major portion as more than 25 percent of the bond proceeds.

[6] The term private loan bond is substituted for the present-law term "consumer loan bond" by Title XVIII of the bill, relating to technical corrections to the Deficit Reduction Act of 1984 (the 1984 Act).

that are part of an issue five percent or more of the proceeds of which is to be used, directly or indirectly, to make or finance loans to persons other than qualified governmental units or section 501(c)(3) organizations.

As with IDBs, interest on private loan bonds is taxable unless a specific exception is provided in the Code for the type of loan for which the bond proceeds are to be used. Present law includes exceptions to the private loan bond restriction for activities with respect to which Congress has provided specifically in the Code that tax-exempt financing is to be available. Thus, exceptions are provided for IDBs, qualified student loan bonds, qualified mortgage bonds, and qualified veterans' mortgage bonds.[7]

Additionally, an exception is provided for loans to nonexempt persons to finance taxes or assessments of general application for specific government facilities (i.e., the financing technique known as tax-assessment bonds). Under this exception, the loans to nonexempt persons for this purpose are disregarded in determining whether interest on bonds is tax-exempt. Rather, the determination of whether such interest is tax-exempt is made by determining whether any further use of the bonds disqualifies the interest on the bonds from tax-exemption. For example, the fact that a qualified governmental unit permits residents generally to pay mandatory assessments levied in connection with sewer, water, or similar specific governmental facilities over a period of years generally is disregarded in determining whether interest on bonds for water or sewer facilities is tax-exempt. That determination is made by reference to the use of the bond-financed property. Thus, if a water or sewer system is owned and operated by a governmental unit, the bonds would be tax-exempt governmental bonds, notwithstanding the indirect loans arising from deferred payment of assessments.

Unlike the IDB use test, the private loan bond restriction applies whether bonds are used to finance personal loans or business loans. For example, an issue may be an issue of taxable private loan bonds if five percent or more, but no more than 25 percent, of the proceeds are used to make loans that would be considered IDB financing, except for the fact that bonds are not treated as IDBs if no more than 25 percent of the proceeds is used to finance an activity satisfying the trade or business use test of the Code (sec. 103(b)(2)(A)). Similarly, an issue may violate this restriction in some cases where the bonds issued as part of the issue are not IDBs because the security interest test is not satisfied (sec. 103(b)(2)(B)).

The concepts of use and loan

Concept of use

General rules.—The use of bond proceeds and of bond-financed property is the basis for determining whether bonds are issued for general governmental operations or for an activity of a nongovern-

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[7] Certain private loan bond programs in existence when this restriction was enacted also are not subject to the requirement. *See*, sec. 626(b) of the 1984 Act. These include certain supplemental student loan bond programs; the Texas Veterans' Land Bond Program, a program that had been continuously in effect in substantially the same form for more than 30 years before the enactment of the 1984 Act; and a small-scale energy Conservation program authorized by section 243 of the Crude Oil Windfall Profit Tax Act of 1980.

mental person. Under present law, the principal application of the use concept is the determination of whether a bond is an IDB.

The ultimate beneficiaries of the bond-financed property generally are treated as the user of the bond proceeds and of the bond-financed property. A person may be a user of bond proceeds or a user of bond-financed property whether the use is direct or indirect. In general, a person is a user of bond proceeds if that person's use of any facility financed with those proceeds is other than as a member of the general public.[8] A person may be treated as a user of bond proceeds or bond-financed property as a result of (1) ownership of property or (2) actual or beneficial use of property pursuant to a lease, a management contract, or an arrangement such as an output contract. (*See*, Treas. Reg. sec. 1.103-7 (b)(3), (b)(5) and (c).)

Use pursuant to certain management contracts.—The determination of whether private use pursuant to a management contract is treated as trade or business use is made on a facts and circumstances basis. The Treasury Department has stated that, under certain specified conditions, it will issue an advance ruling that a facility managed by a private management company is *not* considered to be used in that company's trade or business. Such a ruling generally will be issued only if—

(1) The management services are provided in return for a reasonable, periodic flat fee, under a contract not exceeding 5 years' duration (including renewal options), with the exempt owner having the option to cancel the contract at the end of any 2-year period, or

(2) In the case of certain newly operational facilities, compensation is based on a percentage of gross revenues from the facility, for a period which generally may not exceed one year.

To qualify under (1) or (2) above, the owner of the facilities and the management company must not be subject to common control, with allowances for *de minimis* cases (Rev. Proc. 82-14, 1982-1 C.B. 459).

Similar principles are applied in determining whether advance rulings will be issued, where bond-financed hospitals or similar facilities are used by nonexempt persons other than employees (e.g., use of public or charitable hospitals by private physicians) (Rev. Proc. 82-15, 1982-1 C.B. 460).

Concept of loan

In addition to the concept of use, present law uses the concept of loan to determine whether interest on bonds of qualified governmental units is tax-exempt (i.e., the private loan bond restriction). A loan may result from the direct lending of bond proceeds or may arise from transactions in which indirect benefits that are the economic equivalent of a loan are conveyed. Thus, the determination of whether a loan is made depends on the substance of a transaction, as opposed to its form.

For example, a lease or other contractual arrangement (e.g., a management contract or an output or take-or-pay contract) may in substance constitute a loan even if on its face, such an arrangement does not purport to involve the lending of bond proceeds. A

[8] Similarly, the use of bond proceeds is treated as use of any property financed with the proceeds.

lease or other deferred payment agreement with respect to a bond-financed facility that is not in form a loan generally is not treated as a loan of bond proceeds unless the agreement transfers tax ownership to a nongovernmental person. Similarly, an output or management contract with respect to a bond-financed facility generally is not treated as a loan of bond proceeds unless the agreement in substance shifts significant burdens and benefits of ownership to the purchaser or manager.

The concepts of loan and use are related in that in every case in which a loan is present, the borrower is a user of bond proceeds or bond-financed property. On the other hand, certain limited uses of bond proceeds or bond-financed property may not give rise substantively to a loan.

Exceptions for certain bonds for nongovernmental persons

Industrial development bonds

As described above, interest on IDBs is tax-exempt only if the bonds are issued for certain specified exempt activities or for development of industrial parks, or are exempt small issues.

Exempt-activity IDBs

In general.—One of the exceptions pursuant to which interest on IDBs is tax-exempt is where the proceeds of the bonds are used to finance an exempt activity. Under present law, the following exempt activities are eligible for tax-exempt financing: [9]

(1) Projects for multifamily residential rental property;
(2) Sports facilities;
(3) Convention or trade show facilities;
(4) Airports;[10]
(5) Docks and wharves;
(6) Mass commuting facilities;
(7) Parking facilities;
(8) Sewage disposal facilities;
(9) Solid waste disposal facilities;
(10) Facilities for the local furnishing of electrical energy or gas;
(11) Air or water pollution control facilities;
(12) Facilities for the furnishing of water (including irrigation facilities); or
(13) Local district heating and cooling facilities.

Requirements for multifamily residential rental projects.—Tax-exempt IDBs may be issued to finance projects for multifamily residential rental property, if at least 20 percent of the units in the project (15 percent, in targeted areas) are occupied by low- or moderate-income individuals (sec. 103(b)(4)(A)).[11] The determination of

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[9] An additional exempt activity, construction of certain hydroelectric generating facilities, expired after 1985, subject to specified transitional exceptions for certain projects which had previously been docketed with the Federal Energy Regulatory Commission (FERC).

[10] Hotels at or adjacent to an airport may be financed with exempt-activity IDBs for airports if the number of guest rooms is reasonable in relation to the size of the airport (taking into account current and projected passenger usage) and the number and size of meeting rooms (if any) is in reasonable proportion to the number of guest rooms. (Treas. Reg. sec. 1.103-8(e)(2)(ii)(d).)

[11] Bonds issued under section 11b of the United States Housing Act of 1937 that are in substance IDBs must satisfy all Internal Revenue Code requirements applicable to IDBs for multifamily residential rental property to qualify for tax-exemption.

low- or moderate-income is made by reference to rules established under section 8 of the Housing Act of 1937 for determining lower-income families, except that the percentage of family median gross income that qualifies as low or moderate is 80 percent.

Present Treasury Department regulations do not provide specifically that adjustments for family size are to be made in determining the applicable percentage of median gross income to be used under the Code restrictions. However, the Treasury Department has proposed regulations requiring family size adjustments, effective for bonds issued after December 31, 1985 (Prop. Treas. Reg. sec. 1.103-8(b), 50 Fed. Reg. 216 at 46303 (Nov. 7, 1985)). Present Treasury regulations further provide that no unit may be considered as occupied by low- or moderate-income individuals if all of its occupants are students (as determined under sec. 151(c)(4)), no one of whom is entitled to file a joint income tax return.

The low- or moderate-income occupancy requirement must be satisfied continuously during a qualified project period (i.e., 20 percent of the housing units must be occupied by qualifying low- or moderate-income tenants at all times). If a tenant qualifies as a low- or moderate-income tenant when he or she moves into an apartment, however, that tenant continues to be treated as a low- or moderate-income tenant throughout the period the apartment is occupied, regardless of subsequent increases in the tenant's income. A unit vacated by a low- or moderate-income tenant also continues to be treated as occupied by such a tenant until reoccupied, other than for a temporary period (not exceeding 31 days) (Treas. Reg. sec. 1.103-8(b)(5)(ii).

In addition to satisfying tenant income requirements, IDB-financed multifamily residential rental property also is required to remain as rental housing throughout the qualified project period (or, if longer, the remaining term of the bonds). The term qualified project period means the period beginning on the first date on which at least 10 percent of the units in the project are first occupied (or the date on which the IDBs are issued) and ending on the later of the date: (1) that is 10 years after the date on which at least 50 percent of the units are first occupied; (2) that is a number of days after the date on which any units are occupied equal to 50 percent of the number of days in the term of the bonds having the longest maturity; or (3) on which any assistance provided to the project under section 8 of the Housing Act of 1937 terminates.

As indicated above, the low- or moderate-income occupancy requirement is reduced from 20 percent to 15 percent in targeted areas. For purposes of this reduced low- or moderate-income occupancy requirement, the term targeted area means (1) a census tract in which 70 percent or more of the families have incomes that are 80 percent or less of the applicable statewide median family income, or (2) an area of chronic economic distress as determined under statutory criteria (sec. 103A(k)(3)).

Failure to comply with the low- or moderate-income occupancy and rental requirements at any time during the qualified project period results in the interest on the bonds becoming taxable, retroactive to the date of issue. If noncompliance with the requirements is corrected within a reasonable period (at least 60 days) after the noncompliance reasonably should have been discovered, the tax-

exempt status of the bonds is not affected (Treas. Reg. sec. 1.103-8(b)(6)).

Industrial park IDBs

Under present law, tax-exempt IDBs may be used to finance the acquisition or development of land as a site for an industrial park.

Small-issue IDBs

In general.—Present law also permits tax-exemption for interest on certain small issues of IDBs, the proceeds of which are used for the acquisition, construction, or improvement of certain land or depreciable property used in privately owned and operated businesses (the small-issue exception).[12] The small-issue exception is scheduled to expire generally after December 31, 1986; small-issue IDBs to finance manufacturing facilities may be issued under the exception for an additional two years, through December 31, 1988.

Small-issue IDBs are issues having an aggregate authorized face amount (including certain outstanding prior issues) of $1 million or less. Alternatively, the aggregate face amount of the issue, together with the aggregate amount of certain related capital expenditures during the six-year period beginning three years before the date of the issue and ending three years after that date, may not exceed $10 million.[13] In determining whether an issue meets the requirements of the small-issue exception, previous small issues (and in the case of the $10 million limitation, previous capital expenditures) are taken into account if (1) they are incurred with respect to a facility located in the same incorporated municipality or the same county (but not in any incorporated municipality) as the facility being financed with the small-issue IDBs, and (2) the principal users of both facilities are the same, or two or more related, persons.

$40 million limitation.—Interest on small-issue IDBs is taxable if the aggregate face amount of all outstanding tax-exempt IDBs (exempt-activity, industrial park, and small-issue) that would be allocated to any beneficiary of the small-issue IDBs exceeds $40 million. Bonds that are to be redeemed with the proceeds of a new issue are not considered.

Mortgage revenue bonds and mortgage credit certificates

Mortgage revenue bonds (MRBs) are bonds issued to finance the purchase, or qualifying rehabilitation or improvement, of single-family, owner-occupied homes located within the jurisdiction of the issuer of the bonds (sec. 103A).[14] Before 1980, no special restrictions were placed on the issuance of MRBs. The Mortgage Subsidy Bond Tax Act of 1980 limited tax-exemption to two types of MRBs, qualified veterans' mortgage bonds and qualified mortgage bonds.

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[12] The small-issue exception does not apply to obligations to provide multifamily residential rental property. Thus, IDBs to finance residential rental property must be issued under the exempt-activity IDB exception, discussed above.

[13] In the case of facilities with respect to which an Urban Development Action Grant (UDAG grant) has been made under the Housing and Community Development Act of 1974, capital expenditures of up to $20 million are allowed.

[14] As described in the Explanation of Provisions, the bill retitles mortgage subsidy bonds as mortgage revenue bonds.

Qualified veterans' mortgage bonds

Qualified veterans' mortgage bonds are general obligation bonds, the proceeds of which are used to make mortgage loans to veterans. Authority to issue qualified veterans' mortgage bonds is limited to States that had issued such bonds before June 22, 1984, and issuance is subject to State volume limitations based on issuance before that date. These limits and other rules provide for the eventual elimination of authority to issue these bonds. The States qualifying under this restriction are Alaska, California, Oregon, Texas, and Wisconsin. Loans financed with qualified veterans' mortgage bonds may be made only with respect to principal residences and may not be made to acquire or replace existing mortgages.

Qualified mortgage bonds

In addition to the rules applicable to all tax-exempt bonds, qualified mortgage bonds are subject to various restrictions, including a separate set of State volume limitations; various eligibility and targeting rules, including purchase price restrictions, targeted area rules, and a general limitation to first-time homebuyers; special arbitrage restrictions; information reporting requirements; and an annual policy statement requirement. Authority to issue qualified mortgage bonds is scheduled to expire after December 31, 1987.

Mortgage credit certificate alternative to qualified mortgage bonds

Qualified governmental units may elect to exchange all or any portion of their qualified mortgage bond authority for authority to issue mortgage credit certificates (MCCs). MCCs entitle homebuyers to nonrefundable income tax credits for a specified percentage of interest paid on mortgage loans on their principal residences. MCCs generally are subject to the same eligibility and targeting rules as qualified mortgage bonds. The aggregate principal amount of MCCs distributed by an electing issuer may not exceed 20 percent of the volume of qualified mortgage bond authority exchanged by the State or local government for authority to issue MCCs.

Authority to elect to issue mortgage credit certificates expires after December 31, 1987, together with the authority to issue qualified mortgage bonds.

Bonds for section 501(c)(3) organizations

Under present law, religious, charitable, scientific, educational, and similar organizations (described in sec. 501(c)(3)) are treated as exempt persons with respect to the use of bond proceeds. Thus, State and local governments may issue tax-exempt bonds to finance the activities of section 501(c)(3) organizations on a basis similar to that which applies for activities of the governments themselves.[15] The beneficiaries of this type of financing generally are private, nonprofit hospitals and private, nonprofit colleges and universities. This financing is not available with respect to activities of section 501(c)(3) organizations which constitute unrelated trades or businesses.

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[15] These bonds are treated as nongovernmental bonds for purposes of the present-law information reporting requirements (sec. 103(*l*)).

Student loan bonds

Qualified governmental units and qualified scholarship funding corporations may issue tax-exempt bonds to finance student loans. Issuance of these bonds is permitted only in connection with loans guaranteed under the Guaranteed Student Loan (GSL) and Parent Loans for Undergraduate Students (PLUS) programs of the United States Department of Education. Bonds issued in connection with programs other than the GSL or PLUS programs (supplemental student loan bond programs) generally are not tax-exempt under present law.

Tax-exempt bonds authorized by Federal statutes other than the Internal Revenue Code

Several Federal statutes other than the Internal Revenue Code authorize issuance of bonds on which the interest is tax-exempt.[16] Examples of these "non-Code" bonds are housing bonds issued under section 11b of the United States Housing Act of 1937, and certain bonds issued by the District of Columbia and United States possessions (Puerto Rico, the Virgin Islands, American Samoa, and Guam). Since January 1, 1984, non-Code bonds have been subject to the same restrictions as apply to Code bonds, the proceeds of which are used for a similar purpose.

Volume limitations

Three separate volume limitations affect the aggregate volume of bonds for nongovernmental persons that each State (including U.S. possessions) may issue during any calendar year. These limitations apply separately to (1) IDBs and student loan bonds, (2) qualified mortgage bonds, and (3) qualified veterans' mortgage bonds.

IDBs and student loan bonds

The annual volume of most IDBs and all student loan bonds that a State and local issuers therein may issue is limited to the greater of (1) $150 for every individual who is a resident of the State (determined by reference to the most recent estimate of the State's population released by the Bureau of the Census as of the beginning of the calendar year to which the limitation applies), or (2) $200 million. The $150 per capita limitation continues through December 31, 1986, at which time that amount is scheduled to be reduced to $100 to reflect the scheduled termination of small-issue IDBs for facilities other than for manufacturing. (The $200 million minimum will not be reduced at that time.) For purposes of the volume limitations, the District of Columbia is treated as a State (and is entitled to the $200 million minimum limitation); however, U.S. possessions (e.g., Puerto Rico, the Virgin Islands, Guam, and American Samoa) are limited to the $150/$100 per capita amount.

These volume limitations do not apply to IDBs the proceeds of which are used to finance projects for multifamily residential rental property (sec. 103(b)(4)(A)). The volume limitations also do not apply to IDBs the proceeds of which are used to finance con-

[16] The 1984 Act provided that grants of tax-exemption may only be made in a revenue Act, effective after December 31, 1983.

vention or trade show facilities or certain transportation facilities (airports, docks, wharves, or mass commuting facilities), but only if the property financed by the IDBs is owned by or on behalf of a governmental unit.

For purposes of the exception from the volume limitations for certain transportation facilities (i.e., airports, docks, wharves, and mass commuting facilities), IDB-financed property is treated as governmentally owned if no person is entitled to cost recovery deductions or an investment tax credit for any portion of the property. An election to forego cost recovery deductions and an investment credit results in the property being treated as governmentally owned under this provision even though the property may be considered privately owned using general Federal income tax concepts of ownership.

The volume limitations do not apply to obligations that are neither IDBs nor student loan bonds (e.g., bonds issued for section 501(c)(3) organizations for use other than in unrelated trades or businesses, and bonds issued to finance governmental operations).[17]

Qualified veterans' mortgage bonds

The volume of qualified veterans' mortgage bonds that a qualifying State may issue in any calendar year is limited to an amount equal to (1) the aggregate amount of such bonds issued by the State during the period beginning on January 1, 1979, and ending on June 22, 1984,[18] divided by (2) the number (not to exceed five) of calendar years after 1979 and before 1985 during which the State actually issued qualified veterans' mortgage bonds.[19] For purposes of this limitation, certain obligations with a term of one year or less that are used to finance property taxes on residences financed with these bonds are taken into account at 1/15th of their actual principal amount.

Qualified mortgage bonds

The aggregate annual volume of qualified mortgage bonds that a State, and local issuers therein, may issue is limited to the greater of (1) nine percent of the average annual aggregate principal amount of mortgages executed during the three preceding years for single-family, owner-occupied residences located within the State, or (2) $200 million. This volume limitation is separate from, and in addition to, the volume limitations imposed with respect to student loans bonds and most IDBs and qualified veterans' mortgage bonds (discussed above).

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[17] The State of Texas has a program called the Texas Veterans' Land Bond Program under which general obligation bonds are issued for the purchase of land. Loans under this program are limited to $20,000 per veteran. Where the proceeds of such a bond issue, other than an amount that is not a major portion of the proceeds, are used, for example, for the acquisition of land for recreational or other nontrade or business purposes of its owners, the issue is not subject to the Texas state volume limitation.

[18] This determination is made without regard to bonds issued during the calendar year (or portion thereof) during this period when the lowest volume of such bonds was issued.

[19] This determination is made without regard to any bonds issued by the State after June 22, 1984.

Arbitrage restrictions

General restrictions applicable to all bonds

Permissible arbitrage profits

Interest on any otherwise tax-exempt obligation is taxable if the obligation is an arbitrage bond. An arbitrage bond is defined as an obligation that is part of an issue all or a major portion (more than 15 percent) of the proceeds of which are reasonably expected to be used (directly or indirectly) to acquire taxable obligations that produce a materially higher yield than the yield on the tax-exempt obligations (or to replace funds that are so used).[20]

The determination of whether investment of bond proceeds in materially higher yielding obligations is reasonably expected generally is made on the date the bonds are issued. The Internal Revenue Service has ruled that subsequent deliberate and intentional acts to produce arbitrage occurring after bonds are issued are not protected by the reasonable expectations test. (*See*, Rev. Rul. 80–91, 1980–1 C.B. 29, Rev. Rul. 80–92, 1980–1 C.B. 31, and Rev. Rul. 80–188, 1980–2 C.B. 47.) Exceptions to the general arbitrage rules are provided for materially higher yielding obligations that do not exceed a minor portion of the bond proceeds and for obligations held for certain initial temporary periods (discussed below).

Treasury Department regulations provide rules for determining when an obligation acquired with the proceeds of tax-exempt bonds has a yield materially higher than the bond yield. These regulations apply separate arbitrage restrictions to acquired purpose obligations and acquired nonpurpose obligations acquired with the proceeds of tax-exempt bonds. Acquired purpose obligations are obligations acquired to carry out the governmental purpose of the bond issue. All other obligations acquired with bond proceeds are acquired nonpurpose obligations.

Permissible arbitrage on acquired purpose obligations (other than for bonds issued in connection with certain governmental programs such as student loan bonds) generally is limited, so that the issuer may earn a spread between the yield on the bonds and the yield on acquired purpose obligations not exceeding 0.125 percentage points plus reasonable administrative costs. Administrative costs basically are the costs of issuing, carrying, or redeeming the bonds, the underwriter's discount, and the costs of acquiring, carrying, redeeming, or selling acquired purpose obligations.

Permissible arbitrage on acquired nonpurpose obligations generally is restricted to an amount not exceeding 0.125 percentage points. Additional yield restrictions apply to refundings, overissuances, investments in sinking funds, and other indirect and replacement proceeds of a bond issue.

There are two principal exceptions to the general arbitrage rules. First, unlimited arbitrage earnings are permitted on proceeds invested for a temporary period prior to use, whether held by the issuer or the user of bond proceeds. An issuer may waive the tem-

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[20] Proceeds subject to arbitrage restrictions are defined in Treasury Department regulations to include original proceeds, investment proceeds, amounts accumulated in a sinking fund, other amounts replaced by bond proceeds, and transferred proceeds of a refunding issue. (Treas. Reg. sec. 1.103–13, –14).

porary period and receive an arbitrage spread of 0.5 percentage points with respect to acquired obligations. Second, unlimited arbitrage is permitted on investments held in a reasonably required reserve or replacement fund. All amounts held in such a reserve fund are applied against the 15 percent minor portion that may be invested without regard to yield restrictions. Since an issue may not be increased deliberately to take advantage of the minor portion rule (*see*, Treas. Reg. sec. 1.103–13(j)), reserve funds are the most important example of a minor portion on which unlimited arbitrage earnings are permitted.

In the case of student loan bonds and other obligations issued in connection with certain governmental programs, permissible arbitrage on acquired purpose obligations that are acquired in connection with the program (acquired program obligations) generally is limited to a spread between the interest on the bonds and the interest on the acquired program obligations equal to the greater of (1) 1.5 percentage points plus certain administrative costs, or (2) all reasonable direct costs of the loan program (including issuance costs and bad debt losses). Special allowance payments (SAPs) made by the Department of Education are not taken into account in determining yield on student loan bonds. If student loan repayments are placed in a revolving fund, a new temporary period commences when each deposit to the fund is made (Treas. Reg. sec. 1.103–14(b)(11)).

Determination of bond yield

The determination of whether bonds are arbitrage bonds depends on a comparison of the yield on the bonds and the yield on the acquired obligations. Certain adjustments are permitted that either increase bond yield or decrease the yield on acquired purpose obligations. The case of *State of Washington* v. *Commissioner,* 692 F.2d 128 (D.C. Cir., 1982), held that bond yield is the discount rate which, when used in computing the present value of all payments of principal and interest on the bonds, produces an amount equal to the net proceeds of the issue after deduction of the costs of issuing the bonds. Because costs are deducted pursuant to the *State of Washington* decision in determining net proceeds, there is a corresponding increase in the bond yield. Therefore, under this case, the bond issuer is permitted a higher yield on the investment of bond proceeds and may, in effect, pay issuance costs out of arbitrage profits.

Additional arbitrage restrictions on most IDBs

Rebate requirement

IDBs, other than IDBs for multifamily residential rental property, are subject to additional arbitrage restrictions. Under these additional restrictions, certain arbitrage profits earned on nonpurpose obligations acquired with the gross proceeds of the IDBs must be rebated to the Federal Government. No rebate is required if all proceeds of an issue are expended within six months of the issue date for the governmental purpose for which the bonds are issued. Additionally, if less than $100,000 is earned on a bona fide debt service fund with respect to an issue in a bond year, arbitrage

earned on the fund in that year is not subject to the rebate requirement, unless the issuer elects to consider those earnings when determining if a rebate otherwise is due with respect to the bonds.

For purposes of these additional IDB restrictions, nonpurpose obligations generally include all investments other than those specifically made to carry out the governmental purpose for which the IDBs are issued. The proceeds subject to this requirement include the original proceeds of the borrowing, the return on investments of the bond proceeds, and other amounts used to pay debt service on the bonds. Arbitrage profits that must be rebated include both income earned on investment of the bond proceeds in nonpurpose obligations and earnings on that income.

Ninety percent of the rebate required with respect to any issue must be paid at least once each five years, with the balance being paid within 30 days after retirement of the bonds. Failure to rebate arbitrage profits as required renders the bonds taxable as of the date of issue.

Limitation on investment in nonpurpose obligations

In addition to the rebate requirement, the amount of IDB proceeds that may be invested in nonpurpose obligations at a yield above the bond yield generally is restricted to an amount equal to 150 percent of annual debt service. This limitation does not apply to amounts invested for certain initial temporary periods or to amounts held in a bona fide debt service fund. Debt service includes interest and amortization of principal scheduled to be paid with respect to an issue for the bond year, but does not include payments with respect to bonds that are retired before the beginning of the bond year.

Determination of bond yield

Under the additional IDB arbitrage restrictions, the determination of bond yield is made in a manner consistent with the original issue discount rules of the Code (secs. 1273 and 1274). Bond yield is based on the initial offering price to the public (excluding underwriters, dealers, and brokers). Unlike the rule under *State of Washington v. Commissioner, supra.*, the bond issuer may not increase bond yield by taking costs of issuance into account (sec. 103(c)(6)(H)(iii)).

Additional arbitrage restrictions on qualified mortgage bonds

Additional arbitrage restrictions also are imposed on qualified mortgage bonds.[21] These restrictions apply both to arbitrage earned on mortgage investments and on nonmortgage investments.

Mortgage investments

The effective rate of interest on mortgage loans provided with the proceeds of an issue of qualified mortgage bonds may not exceed the yield on the issue by more than 1.125 percentage points. This determination is made on a composite basis for all mortgage loans financed with the proceeds of the issue. Consequently, the ef-

[21] Qualified veterans' mortgage bonds are not subject to any additional arbitrage restrictions beyond the restrictions imposed on tax-exempt bonds generally.

fective interest rate on some mortgage loans is permitted to be greater than 1.125 percentage points above the yield on the issue, if other mortgages have a lower effective interest rate.

Nonmortgage investments

As under the additional arbitrage restrictions for most IDBs, the amount of qualified mortgage bond proceeds that may be invested at an unrestricted yield in nonmortgage investments is limited to 150 percent of the debt service on the issue for the year. Exceptions to the 150-percent of debt service rule are provided for proceeds invested for initial temporary periods and for temporary periods related to debt service. Arbitrage earned on nonmortgage investments must be paid or credited to the mortgagors or paid to the Federal Government.

Determination of bond yield

Bond yield is determined for purposes of the additional arbitrage restrictions on qualified mortgage bonds using the same method as under the additional restrictions on most IDBs.

Additional arbitrage restrictions on student loan bonds

The 1984 Act directed the Congressional Budget Office and the General Accounting Office to conduct a study of appropriate additional arbitrage restrictions to apply to student loan bonds, and to report to Congress by April 18, 1985.[22] The 1984 Act further directed the Treasury Department to adopt new arbitrage restrictions on these bonds, and provided that restrictions similar to the additional restrictions adopted in that Act for most IDBs may apply to student loan bonds. Additionally, the 1984 Act provided that these regulations could eliminate the rule providing special treatment of SAPs included in the general arbitrage restrictions applicable to all tax-exempt bonds. These new arbitrage restrictions generally would apply to bonds issued six months after their adoption.

SLGS program

To enable issuers of State and local government bonds to avoid impermissible arbitrage profits, the Treasury Department issues a special State and Local Government Series (SLGS) of Treasury obligations. Interest rates on SLGS are set by reference to the permitted yield on each issue of tax-exempt bonds. The minimum maturity is 45 days. Purchasers of SLGS are required to give Treasury 20 days' notice of their intent to purchase these securities.

Advance refundings

In the case of IDBs and mortgage revenue bonds,[23] interest on refunding bonds is tax-exempt only if the refunding bonds are issued no more than 180 days before the refunded issue is redeemed (i.e., the refunded and the refunding issues may not be outstanding simultaneously for more than 180 days). Interest on re-

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[22] This study has not yet been submitted to Congress.

[23] This restriction applies to qualified mortgage bonds, to qualified veterans' mortgage bonds, and to mortgage revenue bonds issued before enactment of the Mortgage Subsidy Bond Tax Act of 1980.

funding bonds that are outstanding for more than 180 days before the refunded IDBs or mortgage revenue bonds are redeemed (advance refunding bonds) generally does not qualify for tax-exemption (Prop. Treas. Reg. sec. 1.103-7(e) and sec. 103A(n)). Advance refundings are permitted in the case of bonds the proceeds of which are used for general government operations or by charitable organizations (described in Code sec. 501(c)(3)).

A refunding issue (other than an advance refunding) generally is considered to be used for the same purposes as the issue being refunded. For example, to the extent the proceeds of the refunded issue were used for an exempt activity under the rules applicable to IDBs, the refunding obligation also is considered to be so used.

Miscellaneous other restrictions on IDBs

Application of IDB proceeds to purpose of borrowing

Exempt-activity IDBs qualify for tax-exemption if substantially all of the bond proceeds are used to finance one or more of the statutorily exempt categories of facilities, including functionally related and subordinate property. Treasury Department regulations provide that the use of 90 percent or more of bond proceeds to provide exempt facilities satisfies the substantially all requirement (Treas. Reg. sec. 1.103-8(a)(1)). Similar rules apply in the case of industrial park and small issue IDBs.

Restriction on maturity of IDBs

The average maturity of any IDBs may not exceed 120 percent of the economic life of the property to be financed. For example, if the proceeds of an issue of IDBs are used to purchase assets with an average estimated economic life of 10 years, the average maturity for the bonds may not exceed 12 years.

Restrictions on acquisition of land and existing property

Present-law includes two restrictions on the circumstances under which land may be financed with IDBs.

Nonagricultural land

Interest on IDBs generally is taxable if more than 25 percent of the proceeds of the issue of which the IDBs are a part is used to finance the acquisition of any interest in nonagricultural land. This restriction applies both to exempt-activity and to small-issue IDBs. The 25-percent restriction is increased to 50 percent in the case of IDBs issued to finance an industrial park (described in sec. 103(b)(5)). An exception to the land acquisition rules is provided for certain land acquired by a public agency in connection with an airport, mass transit, or port development project (described in sec. 103(b)(4)(D)) for a noise abatement, wetland preservation, future use, or other public use, if there is no other significant use of the land after its acquisition and before the expansion occurs.

Agricultural land

Agricultural land may be financed with small-issue IDBs if two conditions are satisfied. First, loans for agricultural land must be limited to first-time farmers, and second, each first-time farmer is

limited to a lifetime maximum of $250,000 of such IDB-financing. A first-time farmer is an individual who has not at any time had any direct or indirect ownership in substantial farmland in the operation of which the individual or the individual's spouse or dependent children have materially participated. Substantial farmland for this purpose includes any parcel of land (1) that is greater than 15 percent of the median size of a farm in the county in which the land is located, or (2) the fair market value of which exceeds $125,000 at any time when the land is held by the individual in question.

A *de minimis* portion of IDB financing provided under this exception may be used for the acquisition of used farming equipment (without regard to the restriction on financing existing property, discussed below). Only equipment acquired within one year after acquisition of the farmland is eligible for tax-exempt financing under this exception.

Authority to issue these bonds expires after December 31, 1986.

Existing property

Tax-exempt IDBs generally may not be used to finance the acquisition of previously used property. As with the restrictions on the acquisition of land, this restriction applies both to exempt-activity and small-issue IDBs. An exception is provided, however, permitting the acquisition of an existing building (and equipment for such a building) if expenditures for rehabilitation of the building and equipment equal or exceed 15 percent of the amount of bonds issued for acquisition of the building and related equipment. A parallel exception also applies to nonbuilding structures (e.g., dry docks), but in such cases, the rehabilitation expenditures must equal or exceed 100 percent of the bond financing.

Cost recovery deductions for bond-financed property

The cost of property that is used in a trade or business or otherwise for the production of income, and that has a useful life of more than one year, may be recovered through depreciation deductions (sec. 168). The present-law Accelerated Cost Recovery System (ACRS) prescribes recovery periods of from 3 years to 19 years. These recovery periods generally are shorter than the economic life of the property. In addition, the ACRS system prescribes a cost recovery method that further accelerates cost recovery by permitting larger deductions in the early years of the recovery period.

Under present law, the cost of property financed with tax-exempt bonds is eligible for recovery over the prescribed ACRS periods, but generally is not eligible for the accelerated cost recovery methods provided by ACRS (sec. 168(f)(12)). Projects for multifamily residential rental property (sec. 103(b)(4)(A)) are not subject to this restriction, and therefore may qualify for both tax-exempt financing and accelerated ACRS deductions.

Information reporting requirements

Issuers of IDBs, student loan bonds, bonds for section 501(c)(3) organizations, and all mortgage revenue bonds must report certain information to the Internal Revenue Service about bonds issued by them during each preceding calendar quarter. This report is due on

the 15th day of the second month after the close of the calendar quarter in which the bonds are issued. Interest is taxable on bonds with respect to which the required information report is not made.

Reasons For Change

General considerations

The committee recognizes the important cost savings that tax-exempt financing may provide for State and local governments. Further, recent reductions in direct Federal expenditures for local governments have increased the importance of these cost savings. Thus, the bill does not restrict the present-law ability of State and local governments to issue tax-exempt bonds for general government operations or for the construction and operation of government facilities, such as schools, roads, government buildings, and governmentally owned and operated sewage, solid waste, water, and electric facilities.

The committee believes that the use of tax-exempt financing for nongovernmental activities should not be unrestricted. The bill generally retains the present-law restrictions on bonds for such activities and makes some modifications that restrict further the use of tax-exempt financing for such activities. The committee determined, however, that efficiencies associated with private involvement in the provision of government services, in certain cases, warrant exceptions from certain restrictions (e.g., State volume limitations) otherwise imposed on tax-exempt financing for private parties.

Between 1975 and 1984, the volume of long-term tax-exempt obligations for private activities (including tax-exempt IDBs, student loan bonds, mortgage revenue bonds, and bonds for use by certain nonprofit charitable organizations) increased from $8.9 billion to $71.8 billion. As a share of total State and local government borrowing, financing for these activities increased from 29 percent to 63 percent. The large increases in the volume of these obligations make tax-exempt financing less efficient and enables high-income individuals and corporations to limit their tax liability, while, in some cases, receiving yields on tax-exempt obligations in excess of the after-tax yields of taxable obligations. Private activities are essentially financed through these indirect Federal subsidies.

The committee also believes that the present-law rules permitting significant arbitrage to be earned and retained by issuers of tax-exempt obligations create an incentive to issue more bonds and to leave such bonds outstanding for a longer period of time than necessary. Although issuers derive a benefit from such arbitrage which, in some cases, may be used for governmental purposes, the cost to the Federal Government of permitting State or local governments to earn and retain arbitrage profits is greater than the revenue loss from any incremental amount of bonds that may be issued absent such arbitrage profits.

Bonds for governmental activities

The bill retains the ability of qualified governmental units to issue tax-exempt debt for the financing of traditional government

activities. The committee understands the importance of this ability for State and local governments.

The committee also recognizes that State and local governments can, in certain cases, achieve significant cost efficiencies through joint public-private partnerships that utilize private management skills to assist in the provision of governmental services. The committee believes that properly restricted private management contracts should not prevent qualified governmental units from issuing tax-exempt obligations to finance the provision of these services. The bill liberalizes present law by expanding the scope of private management contracts that are permitted in conjunction with tax-exempt financing.

The committee is concerned, however, that under present law a significant amount of bond proceeds from governmental issues are being used to finance private activities not specifically authorized by Congress to receive tax-exempt financing. Abuses have been brought to the committee's attention whereby governmental bond issues are structured intentionally to maximize private use without satisfying the present-law IDB trade or business use test or security interest test. The committee wishes to restrict this diversion of governmental bond proceeds for private purposes. The committee has modified the trade or business use test to restrict the use of governmental bond proceeds for private activities unrelated to the governmental purpose of the borrowing. The committee also has clarified the present-law security interest test to include certain payments which are structured with the intent of circumventing the test.

Bonds for section 501(c)(3) organizations

The bill generally continues present-law treatment for bonds issued for section 501(c)(3) organizations to the extent proceeds of those bonds are used to finance activities which are directly related to the exempt purpose of the organization. The committee believes that the services provided to the general public by these organizations warrant continued availability of tax-exempt financing, including availability of that financing without regard to volume limitations like those imposed on private activity bonds and mortgage revenue bonds.

Private activity bonds

The bill continues certain exceptions to the general rule that interest on obligations to finance private activities is taxable.[25] The committee believes that financing for private activities generally should be subject to volume limitations. Thus, the present-law volume restrictions on private activity bonds are retained, including the scheduled reduction to $100 per capita (after 1986) in the volume limitation for student loan bonds and most IDBs.

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[25] The bill permits issuance of tax-exempt bonds for activities of multifamily residential rental property; airports, docks and wharves; sewage, solid waste disposal and water facilities; electric and gas local furnishing systems; local district heating and cooling systems; hazardous waste treatment facilities; small-issue IDBs (subject to present-law sunset dates); qualified redevelopment (tax-increment) bonds; student loan bonds; and mortgage revenue bonds (subject to present-law sunset dates).

The committee understands that governmental units can achieve cost efficiencies by using private operators of certain governmental facilities while still providing a public service to their citizens in a similar manner to services provided directly by the governments. The committee believes that where sewage and solid waste disposal and water facilities are owned by governmental units, operation by private parties generally should not cause financing for these facilities to be treated differently from comparable governmentally owned and operated facilities. Therefore, the bill does not subject tax-exempt financing for these facilities, when governmentally owned, to the volume limitations applicable to most other IDBs. Other bonds not subject to volume limitations include bonds for governmentally owned airports, docks and wharves, and bonds for multifamily residential rental property.

The committee is aware of recent efforts to develop privately owned, operated and financed high-speed rail systems in several densely populated corridors across the country. The development of these systems are consistent with the Administration's privatization initiatives and because of the continuing climate of fiscal restraint, are of increasing importance if we are to keep the pace with the infrastructure and transportation needs of the country. The committee does not intend by its actions respective to tax-exempt bonds to prejudge the possible need for future preferential tax treatment for these large scale projects or to preclude future consideration by the committee of favorable tax treatment of high-speed rail projects.

The bill also restricts the use of private activity tax-exempt bond proceeds for activities not specifically approved for such financing. Under present law, up to 10 percent of IDB proceeds may be used for any activity without violating the tax-exempt status of these private activity bonds. The bill limits this amount to 5 percent.

Arbitrage restrictions

The lower borrowing cost obtained through tax-exempt financing provides the potential to earn arbitrage profits by investing tax-exempt bond proceeds at higher, taxable yields, unless such transactions are restricted. Arbitrage transactions have no economic substance but are made profitable only through the ability to borrow at tax-exempt rates. The ability to earn arbitrage profits provides an incentive to issue more bonds, to issue the bonds earlier, and to leave them outstanding longer. Arbitrage is an inefficient alternative to additional borrowing because it is more costly to the Federal Government in terms of foregone tax revenue than the additional borrowing necessary to produce the same amount of proceeds. The committee has adopted a number of provisions which restrict the ability of issuers of tax-exempt bonds to earn arbitrage profits.

The bill requires a rebate of most arbitrage earned from tax-exempt bonds. The committee determined that permitting State and local governments to earn and retain these profits encourages abuse of the tax exemption for interest on bonds of these entities. The committee chose to require rebate of profits because it believes that prohibiting earning of any profits, through elimination of temporary periods and other exceptions to the arbitrage restrictions,

could prove unduly burdensome administratively. The committee views the rebate requirement as more flexible, but substantively equivalent to prohibiting the earning of arbitrage profits, a move that Congress initially took on a more limited scale in 1969. To eliminate any administrative burden associated with the arbitrage rebate, the committee determined that the Treasury Department should modify it SLGS program to include obligations similar to demand deposits.

The committee believes it is important for issuers of tax-exempt bonds to pay the costs associated with their borrowing. The bill provides that the costs of issuance, including attorneys' fees and underwriters' commissions, must be paid by the issuers or beneficiaries of the bonds, rather than recovered through arbitrage profits at the Federal Government's expense. The committee believes that this restriction will result in a more efficient use of tax-exempt financing, as borrowers will more closely monitor the costs of their borrowing. However, the committee intends to monitor the effect of these provisions to determine whether further restrictions on costs such as attorneys' fees and underwriters' commissions are needed.

The committee also wishes to prevent an abuse of tax-exempt financing by certain governmental units to issue bonds for the purchase of annuity contracts. These transactions are designed to skirt arbitrage restrictions that would apply to direct tax-exempt financing of pension plan liabilities. Thus, the bill treats the investment in annuity contracts comparably with the direct funding of a pension plan.

The committee has also restricted the advance refunding of tax-exempt bonds. Issuers of certain tax-exempt bonds, unlike private borrowers, may advance refund at virtually no cost or risk since the proceeds of an advance refunding may be invested in Federal securities at a yield equal to that of the refunding issue. Advance refunding results in multiple issues of bonds outstanding simultaneously, and thereby results in multiple indirect Federal subsidies attributable to tax-exempt financing for a single activity. For example, bonds for a single building costing $5 million might be advance refunded two or more times so that the Federal Government would be subsidizing $15 million or more in tax-exempt bonds for that one $5 million building. This is unlike refinancing a home mortgage loan where the original loan is retired at the time of the refinancing.

Explanation of Provisions

The bill allows bonds the interest on which is tax-exempt under Code section 103 to continue to be issued by or on behalf of qualified governmental units to finance activities of the governments themselves. These bonds may be issued without regard to (1) the volume limitations that apply to most bonds for activities conducted by nongovernmental persons, and (2) many of the other restrictions that apply to those bonds. As under present law, interest on bonds the proceeds of which are used by nongovernmental persons is taxable unless a specific exception is provided in the Code.

1. Bonds to finance government operations generally

States and local governments may continue to provide tax-exempt financing for general government operations as well as for the construction and operation of such facilities as schools, highways, government buildings, and governmentally owned and operated sewage, solid waste disposal, water, and electric facilities. Additionally, qualified governmental units may continue to issue short-term notes in anticipation of taxes and other revenues (TANs and RANs) to finance cash-flow shortfalls. Similarly, interest on most debt of qualified governmental units that does not involve formal issuance of bonds (e.g., installment purchase agreements and finance leases) is tax-exempt to the same extent that interest on bonds issued for the same purpose would be tax-exempt. As under present law, interest paid by qualified governmental units other than pursuant to the exercise of their borrowing power is not tax-exempt (e.g., interest on tax refunds).

2. Tax-exemption for interest on certain other bonds

Qualified governmental units also may continue to provide tax-exempt financing for certain activities of other persons. Unlike financing for general government operations, interest on these bonds is taxable unless a specific exception is provided in the Code.

Bonds the proceeds of which are used by section 501(c)(3) organizations continue to qualify for tax-exemption under circumstances similar to present law. Other bonds which qualify for tax-exemption include industrial development bonds (IDBs) for certain specified activities, mortgage revenue bonds (i.e., qualified mortgage bonds and qualified veterans' mortgage bonds),[26] and qualified student loan bonds. The bill deletes several exempt activities for which tax-exempt IDB financing may be provided, permits IDB financing for hazardous waste treatment facilities and qualified redevelopment projects, expands the types of student loan bonds eligible for tax-exemption, and makes several changes in other rules, including arbitrage restrictions, applicable to tax-exempt bonds generally.

The bill retains the private (consumer) loan bond restriction of present law.[27] Thus, bonds are private loan bonds if 5 percent or more of bond proceeds is to be used directly or indirectly to make or finance loans to nongovernmental persons (other than section 501(c)(3) organizations). As under present-law, a loan is present regardless of whether bond proceeds are transferred directly to such a nongovernmental person or whether a transaction involves an indirect transfer that is in substance a loan. Interest on bonds that are otherwise private loan bonds qualify for tax-exemption if an ex-

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[26] Certain bonds issued under a program of the State of Texas that has been continuously in existence for more than 30 years and pursuant to which bonds are issued to finance loans to veterans for the purchase of land also may continue to be issued under the bill, without regard to the March 15, 1987, sunset date of the tax-exemption for those bonds that is contained in present law. The exception for bonds issued under a small-scale energy conservation program of the State of Oregon also is retained, and an additional exception is added for certain bonds issued as part of the Iowa Industrial New Jobs Training Program.

[27] These bonds are renamed "private loan bonds" by an amendment contained in the technical corrections portion of the bill (Title XVIII).

ception is specifically provided under the Code (i.e., certain IDBs, mortgage revenue bonds, and student loan bonds).[28]

Related use requirement

The bill retains the present-law rule that up to 25 percent of governmental bond proceeds may be used to finance private trade or business activities. The bill requires, however, that such private trade or business use be related to a governmental facility being financed with the bonds. Under the bill, bonds violate this related use requirement if (1) 5 percent or more of the bond proceeds is to be used directly or indirectly to finance a trade or business use of any person other than a governmental unit and that use is not related to facilities of a governmental units also being financed by the bonds, and (2) payments with respect to the trade or business use are made directly or indirectly by such a person.[29]

The determination of whether a facility used in a trade or business of such a person is related to a governmental facility is factual, and must be made on a case-by-case basis. A facility generally is related to a governmental facility if it is functionally related to the operation of the facility. In many, but not all, cases, this will result in the related facility being located within the governmental facility. For example, a newsstand located in a court house is related to the court house. Similarly, financing for a privately owned cafeteria located in a school is related to financing for the school. On the other hand, assume an issuer takes more than 5 percent of the proceeds of a school bond to build a golf course. The proceeds to build the golf course are not considered functionally related to the purpose of the school bond issue.

Industrial development bonds

As under present law, interest on IDBs issued by or on behalf of qualified governmental units is tax-exempt when the bonds are issued to finance certain specified exempt activities or are small-issue IDBs. (The bill repeals the exemption for industrial park IDBs.) The bill also clarifies the application of the present-law security interest test to certain indirect payments. Amendments further are made to the provisions regarding small-issue IDBs and new exceptions for qualified redevelopment IDBs and hazardous waste disposal facility IDBs are added.

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[28] The present-law exception to the private loan bond restriction provided for the financing technique accomplished with obligations known as tax-assessment bonds also is retained. The committee understands that taxes or other mandatory assessments with respect to the improvements serving an essential governmental function may be levied on a property frontage basis or may be levied on an *ad valorem* basis. The committee intends that this exception apply whether the taxes or other assessments are based on a property frontage basis, an *ad valorem* basis, or any other comparable method that results in equivalent mandatory assessments to all residents benefiting from the improvements.

The committee also wishes to clarify the application of this rule to taxes or other assessments levied on property used in a trade or business. The committee intends that this exception from the private loan bond restriction apply when the assessed property is used in a trade or business as well as when the assessed property is used for nonbusiness purposes. In such cases, the exception applies only if the tax or other assessment is mandatory and for an essential government function and only if both business and nonbusiness property are eligible to make deferred payments of such tax or assessment on an equal basis.

[29] As with the other restrictions on private use of bond proceeds, exceptions are provided for bonds 5 percent or more of the proceeds of which are specifically authorized to be used by private trades or businesses under section 103 of the Code.

Trade or business use and security interest tests

Under the bill, bonds are IDBs if the bonds are part of an issue (1) 25 percent or more of the proceeds of which are to be used, directly or indirectly, in any trade or business carried on by a person other than a governmental unit or section 501(c)(3) organization (the "use test"), and (2) 25 percent or more of the payment of the principal or interest on which is, under the terms of the obligation or any underlying arrangement, directly or indirectly (i) secured by any interest in property used or to be used in a trade or business or in payments in respect of such property, or (ii) to be derived from payments in respect of property, or borrowed money, used or to be used in a trade or business (the "security interest test").

The bill clarifies that both direct and indirect payments to an issuer of bonds made by a private user of bond-financed facilities are considered when determining whether the security interest test, described above, is satisfied. Thus, payments by such private users of bond-financed facilities equal to or exceeding 25 percent of debt service result in the bonds being IDBs, whether or not the payments are formally pledged as security or are directly used to pay debt service on the bonds.

This clarification applies only to payments from persons who are treated as using the bond-financed facility under the use test, described above. For example, revenues from generally applicable taxes are not payments that are considered in determining whether the security interest test is satisfied. On the other hand, special charges imposed on persons satisfying the use test, but not on members of the public generally, would be considered if those charges are in substance fees paid for the use of the bond-financed property.

If bonds are issued to acquire land that is to be sold to private persons for redevelopment, amounts paid by the private persons for the land are payments within the meaning of the security interest test even though incremental tax revenues are the stated security for repayment of the bonds. These payments are considered under the expanded security interest test whether they are made in a lump sum or in installments. The payments are considered whether paid directly to a governmental unit whose tax revenues secure the bonds or to an agency acting on behalf of such governmental unit. Similarly, if a facility is leased to a private user and receipts from a special user tax (e.g., a ticket tax at a stadium) are the formally pledged bond security, the lease payments from the private user are considered for purposes of the security interest test even if the user tax revenues, rather than the lease or other payments, comprise the direct source for repayment of the bonds.

Liberalization of management contract advance ruling guidelines

The bill directs the Treasury Department to liberalize its current published advance ruling guidelines (Rev. Proc. 82-14, *supra*) to provide that a nongovernmental person's use of bond-financed property pursuant to a management contract generally will not be treated as a private trade or business use under the IDB use test if—

(1) the term of a management contract does not exceed five years (including renewal options),

(2) fees provided to any nongovernmental service provider are not based on a share of net profits, and

(3) the governmental unit owning the facility may terminate the contract without cause at the end of three years.

Under these rules, management contracts may provide for fees in a prescribed flat amount or fees determined by reference to a share of gross revenues from the bond-financed facility. Except for the specific changes indicated, the committee does not intend to alter the present-law advance ruling guidelines for determining when nongovernmental use is disregarded for purposes of the IDB use test or to limit the Treasury Department's authority to determine what constitutes a use of bond proceeds.[30]

Exempt-activity IDBs

Exempt activities

Under the bill, an issue is an issue of exempt-activity IDBs only if 95 percent or more of the bond proceeds (as opposed to 90 percent under present law) is used to provide one or more specified exempt facilities. The bill repeals the present-law tax exemption for interest on IDBs to finance sports facilities; convention or trade show facilities; mass commuting facilities; parking facilities; [31] and air or water pollution control facilities.[32] The bill also adds hazardous waste treatment facilities as a new exempt activity.

Exempt-activity IDBs permitted under the bill are as follows:[33]

(1) Projects for multifamily residential rental property, subject to new targeting and compliance rules;

(2) Airports (other than lodging facilities) and docks and wharves;

(3) Sewage and solid waste disposal facilities;

(4) Facilities for the furnishing of water;

(5) Facilities for the local furnishing of electric energy or gas; [34]

(6) Local district heating and cooling facilities; and

(7) Hazardous waste treatment facilities.

Multifamily residential rental property targeting and compliance rules

Required occupancy by low- and moderate-income tenants.—The bill amends the present low- and moderate-income occupancy requirements for multifamily residential rental property to permit issuers of exempt-activity IDBs for multifamily residential rental

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[30] The committee intends that similar changes be made to the advance ruling guidelines as applied to qualified 501(c)(3) bonds (*See*, Rev. Proc. 82–15, *supra*).

[31] Parking facilities which are functionally related and subordinate to other exempt facilities may continue to be financed with tax-exempt IDBs (e.g., airport parking facilities) and also may be financed in certain cases under the small-issue exception.

[32] The exemption for certain hydroelectric generating facilities generally expired after December 31, 1985. While the bill does not reenact this exemption, it does retain a transitional exception for certain facilities for which FERC approval was pending on the date this exemption expired.

[33] Unless otherwise noted, these activities are defined in the same manner as under present law.

[34] As under present law, local furnishing of electricity or gas includes furnishing within two contiguous counties or a city and one contiguous county. Two present-law exceptions under which specified facilities are treated as facilities for the local furnishing of electricity (secs. 644 and 645 of the Deficit Reduction Act of 1984) are retained under the bill.

property to receive financing for projects if either of two set-aside requirements is satisfied.

Residential rental projects may qualify for tax-exempt financing if, at the election of the issuer, either—

(1) 25 percent or more of the units are occupied by tenants having incomes of 80 percent or less of the area median income, or

(2) 20 percent or more of the units are occupied by tenants having incomes of 70 percent or less of the area median income.

The election must be made no later than the date on which the bonds are issued. Once made, the election is irrevocable.

Unlike present law, there are no special rules for multifamily residential rental projects located in targeted areas.

As under present law, the low- or moderate-income occupancy requirement must be satisfied continuously during a qualified project period. Unlike present law, however, the determination of whether a tenant qualifies as having low- or moderate-income is made on a continuing basis, rather than only on the date the tenant initially occupies the unit. An increase in a tenant's income may, therefore, result in a unit ceasing to qualify as occupied by a low- or moderate-income tenant. However, a qualified low- or moderate-income tenant is treated as continuing to be such notwithstanding limited increases in his or her income.

If a tenant qualifies as having low- or moderate-income upon initially occupying a housing unit or on any determination date thereafter, that tenant will be treated as continuing to have such an income as long as his or her family income does not increase to a level more than 20 percent in excess of the maximum income qualifying as low or moderate income, after adjustment for family size, under the standard applicable to the project. However, if the tenant's income increases to a level more than 20 percent above the otherwise applicable limit (or if the tenant's family size decreases so that a lower maximum income applies to the tenant), that tenant generally may no longer be counted in determining whether the project satisfies the low- or moderate-income requirement.

A further special exception is provided for certain projects charging significantly lower-than-market-rate rents to low-income tenants. Under this special exception, a tenant who qualifies as having low- or moderate-income upon initially occupying a housing unit or on any determination date thereafter, is treated as continuing to have such an income as long as his or her family income does not increase to a level above more than 50 percent (rather than 20 percent) in excess of the maximum income qualifying the tenant as low or moderate, after adjustment for family size. Additionally, in such projects, in lieu of the requirement that *each available unit* be rented to a tenant qualifying as having low- or moderate-income after a tenant's income has so increased, *each available low- or moderate-income unit* must be rented to a tenant whose income is 50 percent or less of the area median income.

To qualify for this special exception, the project must elect to satisfy a special low- or moderate-income occupancy requirement. In lieu of the low- or moderate-income occupancy requirements required for qualified residential rental projects generally, a project must elect a special two-tier low- or moderate-income occupancy requirement. Under this special rule, projects must elect to have at

least one-fourth (25 percent) of the otherwise applicable low- or moderate income units occupied by tenants having incomes of 50 percent or less of the area median income. Thus, in a 100 unit project otherwise electing 20-percent low- or moderate-income occupancy requirement, at least 5 units must be occupied by tenants having 50 percent or less of the area median income. This special 50-percent-of-area-median-income set-aside must be elected when a low- or moderate-income occupancy requirement is initially elected for a project, and applies throughout the qualified project period in the same manner as the regular occupancy requirement.

The committee does not intend, however, that tenants be evicted to return a project to compliance under either the general rule or the special exception. Rather, each residential rental unit that becomes vacant while a project is not in compliance with the low- and moderate-income occupancy aside requirement must be rented to a tenant having a low or moderate income before any comparably sized or smaller units in the project are rented to tenants not so qualifying, until such time as the project again is in compliance. (This rule also applies if the rental of the unit to a nonqualifying tenant would itself cause the occupancy requirement to be violated). In general, therefore, the event that gives rise to penalties for noncompliance is rental of a comparably sized or smaller unit to other than a low- or moderate-income tenant (on other than a temporary basis) during any period when the project does not comply with the low- or moderate-income occupancy requirement (or would not qualify as a result of that rental). As under present law, rental of a unit vacated by a low- or moderate-income tenant to other than a low- or moderate-income tenant may result in noncompliance.

The bill also clarifies that present law requires that adjustments for family size be made in determining the area median incomes used to qualify tenants as having low or moderate income. In general, these adjustments are the same as the adjustments presently made under section 8 of the United States Housing Act of 1937. Thus, if a project qualifies by having 25 percent of the units occupied by tenants having incomes of 80 percent or less of area median income, a family of four generally will be treated as having a low- or moderate-income if the family has an income of 80 percent or less of the area median income; a family of three having an income of 72 percent or less generally will qualify; a family of two having an income of 64 percent or less generally will qualify; and, a single individual having an income of 56 percent or less generally will qualify. The committee intends that similar 10-percent reductions be made to reflect family size if the option of having 20 percent of the units occupied by tenants having incomes of 70 percent

or less of area median income is elected. The committee is aware that, in certain cases, continuing the present-law use of section 8 guidelines may result in qualifying incomes below the amounts reflected by these percentages because of dollar ceilings that are applied under the section 8 program.

Qualified project period.—Bond-financed residential rental projects must remain as rental property and must satisfy the low- or moderate-income occupancy requirement, described above, throughout a prescribed qualified project period. The bill redefines the qualified project period as the period beginning on the date on which at least 10 percent of the units in the project are first occupied (or, if later, the date on which the exempt-facility bonds are issued) and ending on the latest of (1) the date that is 12 years after the date on which at least 50 percent of the units are first occupied; (2) the first date on which no tax-exempt bond used to finance the project remains outstanding; or (3) the date on which any assistance provided with respect to the project under section 8 of the Housing Act of 1937 terminates.

Annual certification of compliance.—Under the bill, operators of bond-financed multifamily residential rental projects must certify compliance with the low- and moderate-income occupancy requirement applicable to these exempt facilities to the Treasury Department on an annual basis. The committee intends that the Treasury Department may require in the certification such additional data as it deems necessary to monitor compliance with this requirement. In general, the required certification will be made by operators of projects as agents of the project owners; however, under the bill, project owners are liable for a new penalty as a result of any failure on the part of the operators to make complete and timely reports. Failure to make required reports does not in itself affect the tax status of bond interest, but results in imposition of a penalty (discussed below).

Correction of and penalty for noncompliance with rental use, and annual certification requirements.—As under present law, owners and operators of bond-financed residential rental property must correct any post-issuance noncompliance with the low- or moderate-income occupancy requirement within a reasonable period after the noncompliance is discovered or reasonably should have been discovered.

The bill provides two penalties for failure to comply with the low- or moderate-income occupancy and rental use requirements during the qualified project period. First, as under present law, interest on the bonds used to finance the project becomes taxable, retroactive to the date of their issuance. In addition to this present-law rule, failure to correct any noncompliance with the low- or moderate income occupancy requirement within a reasonable period after it is discovered or reasonably should have been discovered, or termination of use as rental property, results in all interest on bond-financed loans being nondeductible, effective from the first day of the taxable year in which the noncompliance occurred.[35] If the noncompliance arises solely because of failure to

[35] For a more complete discussion of new rules governing deductibility of interest on bond-financed loans, see the discussion below regarding changes in use of bond-financed property.

satisfy the low- or moderate income occupancy requirement, interest incurred on bond financed loans after a project is again in compliance with that requirement is deductible. Interest on the bonds, however, remains taxable (as under present law).

The bill provides a special penalty for failure to make the required annual certification of compliance with the low- and moderate-income set-aside requirement. This penalty is equal to $100 for each failure to comply and is in lieu of loss of tax-exemption on the bonds or denial of deductions for interest on bond-financed loans. For purposes of applying the penalty, a separate failure to comply occurs each day after the due date that a report is not filed. Likewise, reports with respect to each project owned by one person or a group of related persons are separate reports, with any penalty being imposed independently for each such project's required report.

Annual report to Congress by Treasury Department.—The Treasury Department is required to make an annual report to the Committee on Ways and Means and the Committee on Finance on compliance with the low- or moderate-income occupancy requirement with respect to bond-financed residential rental projects.

Hazardous waste treatment facilities

The bill adds an exemption for interest on IDBs used to finance facilities for the treatment of hazardous waste. The terms "treatment" and "hazardous waste" for this purpose have the meanings provided under section 1004 of the Solid Waste Disposal Act. The exemption is limited to facilities which are subject to final permit requirements under the Resource Conservation and Recovery Act (RCRA) (subtitle C of Title II of the Solid Waste Disposal Act), as in effect on the date of the bill's enactment. The committee intends that rules similar to the present-law rules regarding solid waste disposal IDBs will apply to these bonds, including rules limiting hazardous waste to materials having no market or other value at the place at which they are located and rules limiting tax-exempt financing to that portion of a facility which is actually engaged in the treatment of hazardous waste (*see, e.g.*, Treas. Reg. sec. 1.103–8(f)(2) and Temp. Treas. Reg. sec. 17.1).

Exception for qualified redevelopment IDBs

In general

The bill provides tax-exemption for the interest on a new category of IDBs issued by qualified governmental units, qualified redevelopment bonds.[36] Qualified redevelopment bonds are bonds which are part of an issue (1) 95 percent or more of the proceeds of which are to be used for certain specified redevelopment purposes

[36] Bonds the proceeds of which are used to finance such governmental facilities as street paving, sidewalks, street-lighting, and similar facilities are governmental bonds, and thus are not subject to the new requirements for qualified redevelopment bonds if the restrictions of sections 103(b)(2), (o) and (p) are not violated. The committee further understands that both governmental activities and private activities currently may be financed with a single issue of tax increment financing bonds. The committee intends that the Treasury Department will develop rules for allowing such umbrella financing to continue by treating the governmental facility component and the qualified redevelopment bond component of a single issue as separate issues in appropriate circumstances.

in a locally designated blighted area, and (2) with respect to which property tax revenues (or their equivalent) attributable to any increase in real property values by reason of bond-financed redevelopment is reserved exclusively for debt service on the issue (and other qualified redevelopment bond issues),[37] to the extent necessary to cover such debt service. The fact that a local government lends its full faith and credit or pledges other taxes such as sales tax revenues from the blighted area to these bonds, in addition to earmarking incremental property tax revenues, does not affect the bonds' status as qualified redevelopment bonds.

Real property taxes imposed in the designated blighted area must be imposed at the same rate and in the same manner as taxes on other real property located in the same jurisdiction. Additionally, no owner or user of property in the designated area may be subject to a charge or fee (other than real property taxes) which is not imposed on similarly situated owners or users in the designated area or elsewhere in the jurisdiction.

Qualified redevelopment bonds may be issued only pursuant to a State law which authorizes the issuance of such bonds for use in blighted areas. Additionally, the bonds must be issued pursuant to a redevelopment plan adopted by the governing body of the general purpose local governmental unit (e.g., the city, or if not located in a city, the county) having jurisdiction over the designated blighted area, before the issuance of the bonds. However, the committee does not intend to require existing redevelopment agencies, which have, as of the date this bill is reported, adopted redevelopment plans pursuant to State law, to resubmit a redevelopment plan to the governing body of the general purpose governmental unit having jurisdiction over the designated blighted area. *See*, however, the discussion below on the 25 percent limit on areas that may be designated as blighted by any governmental unit.

Qualified redevelopment bonds may not be repaid directly, and the repayment of the bonds may not be secured, by any nongovernmental person, other than by means of incremental real property tax revenues (as described above) to the extent that such pledging or repayment would render the bonds IDBs under present law.

Qualified redevelopment activities

Qualified redevelopment bonds may be used only for specified redevelopment activities. The activities for which these bonds may be issued are (1) to acquire (pursuant to the power of eminent domain or the threat of exercise thereof) real property in a designated blighted area, which real property is subsequently to be transferred to persons other than governmental units for fair market value (determined including covenants and restrictions relating to the use of real property), (2) to clear and prepare land in a designated blighted area for redevelopment and transfer to such persons, (3) to rehabilitate the real property, and (4) to relocate occupants of structures on the acquired real property. Qualified redevelopment bonds may not to be used to construct new buildings or similar structures in a redevelopment area.

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[37] For this purpose, tax-increment bonds (as defined in sec. 1869(c) of the bill) which are issued before the date of enactment are treated as qualified redevelopment bonds.

Designation of blighted areas

Only activities in specially designated blighted areas may be financed by qualified redevelopment bonds. The designation of blighted areas is to be based on State statutory criteria taking into consideration the presence of the following factors in the area: excessive vacant land on which structures were previously located; abandoned or vacant buildings; structurally substandard buildings; old buildings generally; excessive vacancies; and delinquencies in the payment of real property taxes. However, subject to the 25 percent limit on designated blighted areas, discussed below, the committee does not intend to require redevelopment agencies to reexamine the criteria originally used to designate blighted areas because some plans were approved over 30 years ago and it would be burdensome, if not impossible, to require such retroactive analysis. Thus, redevelopment plans established pursuant to State law, prior to the date the bill was ordered reported, are deemed to have satisfied the State statutory criteria requirement.

The aggregate blighted areas designated by any governmental unit may not contain real property the assessed value of which exceeds 25 percent of the total assessed value of all real property located within the jurisdiction of the governmental unit, using property values determined on the date of designation of each redevelopment area.[38] Additionally, no blighted area may be smaller than 10 contiguous acres. The committee intends that the designation of blighted areas will be made in contemplation of a redevelopment of the entire designated area and that areas will not be artificially designated in order to allow bond financing for one or a few specific facilities which happen to be located within the area. The committee also intends that local jurisdictions that presently have areas in excess of the 25 percent maximum designated as blighted will review those areas to reduce the aggregate areas eligible for redevelopment activities financed with these bonds before being eligible to issue qualified redevelopment bonds.

For purposes of designating redevelopment areas, general purpose local governmental units are the smallest governmental units having general purpose sovereign powers over a given area.[39] Thus, in most cases, designations will be made by cities or (for areas outside any city) by county governments. The State itself and special purpose governmental units (e.g., a redevelopment authority or agency) are not treated as a governmental unit entitled to designate blighted areas.[40]

Restrictions on certain uses of proceeds

Qualified redevelopment bonds are IDBs and hence are subject to the private activity bond volume limitation and to the other limitations applicable to IDBs, other than the rules regarding acquisition of land.

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[38] An area is treated as a designated area for purposes of this restriction until all qualified redevelopment bonds used to finance activities therein are redeemed.

[39] This is similar to the test applied for purposes of allocating bond authority among overlapping units, under the private activity bond volume limitation.

[40] The State is, however, required to establish the criteria for designating these areas, as described above.

Additionally, not more than 25 percent of qualified redevelopment bond proceeds may be used for facilities with respect to which IDB financing is restricted under secs. 103(b)(6)(O) or 103(b)(18) of present law (including land on which such facilities are or are to be located), and no bond proceeds may be used to finance the following facilities (on land on which such facilities are located): (i) private or commercial golf courses; (ii) country clubs; (iii) massage parlors; (iv) hot tub facilities; (v) suntan facilities; (vi) racetracks or other facilities used primarily for gambling.

Small-issue IDBs

General rules

The exemption for interest on small-issue IDBs is retained by the bill, subject to the present-law sunset dates (December 31, 1986, for bonds other than bonds for manufacturing facilities, and December 31, 1988 for bonds for manufacturing facilities). As in the case of exempt-activity IDBs, 95 percent or more of bond proceeds are required to be used for the exempt purpose of the borrowing.

First-time farmer exception

The bill includes several modifications to the provisions regarding small-issue IDBs for agricultural purposes. First, bonds for first-time farmers [41] are treated as manufacturing bonds for purposes of the small-issue sunset; therefore, these bonds may continue to be issued until December 31, 1988. Second, the definition of first-time farmer is expanded to include farmers who qualify at the time a loan is made, except for prior ownership of land which was disposed of while insolvent (within the meaning of Code sec. 108). Third, the bill allows first-time farmers to use up to 25 percent of the maximum of $250,000 in financing available to them under the first-time farmer exception (i.e., a maximum of $62,500) to acquire used agricultural equipment. (Under present law, only a *de minimis* amount of bond proceeds may be so used.) Additionally, financing for this used equipment is not required to be provided in conjunction with financing for farmland. As under present law, the $250,000 amount is a lifetime limit, except in the case of land financed for farmers qualifying under the special insolvency exception.

Aggregate limit on depreciable property used in farming

The bill restricts the aggregate amount of small-issue IDB financing for all types of depreciable farm property (including both new and used property) to no more than $250,000 for any person (or related persons). This $250,000 limit is a lifetime limit (including financing provided before the date of the bill's enactment).[42] Amounts of depreciable property financed under the first-time farmer exception, discussed above, are counted toward the limit. A person is treated as receiving small-issue IDB financing for all

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[41] The first-time farmer rule is an exception to the general rule prohibiting the use of IDBs to acquire agricultural land (*see*, discussion in Present Law, above).

[42] While bonds issued before the date of the bill's enactment are counted in determining whether a person has exceeded the $250,000 limit, this will not result in interest on any such bonds becoming taxable.

property of which the person (or a related person) is a principal user, as defined under the small-issue IDB exception.

Mortgage revenue bonds and mortgage credit certificates

Mortgage revenue bonds and MCCs

The bill retitles mortgage subsidy bonds as mortgage revenue bonds, but otherwise generally retains present-law rules for these bonds, including December 31, 1987, sunset date for qualified mortgage bonds.

The alternative of electing to issue mortgage credit certificates in lieu of qualified mortgage bonds is retained; however, the trade-in rate is increased from 20 percent to 25 percent of the exchanged bond authority. Authority to elect to issue MCCs, like authority to issue qualified mortgage bonds, will expire after December 31, 1987.

Limited equity housing cooperatives

The bill provides that limited equity housing cooperatives are eligible, at the election of the cooperative, for tax-exempt financing using the multifamily residential rental project targeting and other compliance rules applicable to IDBs for such property. Limited equity housing cooperatives are cooperative housing corporations (as defined under sec. 216(b)(1)) in which a person is entitled to occupy a dwelling unit by reason of ownership of stock in the cooperative. To qualify for financing as a qualified residential rental project, (1) the cost of any stock in the cooperative must not exceed the amount paid for the stock by the original stockholder (as adjusted for cost-of-living increases), increased by amounts paid for improvements on the stockholder's house or apartment and certain other payments attributable to the stockholder, and (2) the assets of the cooperative in excess of the combined transfer values of outstanding stock in the cooperative (reduced by any liabilities) must be used only for public or charitable purposes or directly to benefit the cooperative and must not be used directly to benefit any stockholder.

The bill provides that, where a limited equity housing cooperative elects to qualify for tax-exempt financing under the multifamily residential rental property targeting and compliance rules, the cooperative's tenant shareholders will not be entitled to a deduction for their ratable share of interest and taxes paid by the cooperative (under sec. 216). Additionally, bonds issued to finance units in the cooperative will be counted toward the State's volume limitation for qualified mortgage bonds, but will be treated as IDBs for multifamily residential rental property for all other purposes of the Code. The election to be eligible for financing as multifamily residential rental property is to be irrevocable and applies only if the cooperative continues to qualify as a limited equity cooperative throughout the period any tax-exempt bonds are outstanding.

If an election as described above is not made, a limited equity housing cooperative is eligible for qualified mortgage bond financing on the same basis as other owner-occupied housing. Such financing is subject to all the limitations applicable to qualified

mortgage bonds (including the first-time purchaser and purchase price limitations).

Qualified 501(c)(3) bonds

General rules

The bill permits continued tax-exemption for interest on bonds issued for the use of section 501(c)(3) organizations (qualified 501(c)(3) bonds) if the proceeds of the bonds are used in activities directly related to the exempt purpose of the organizations. Under the bill, interest on bonds for section 501(c)(3) organizations is tax-exempt only if no more than 5 percent of the proceeds of the bonds is used directly or indirectly in a trade or business of any person other than a section 501(c)(3) organization or a governmental unit or used to make or finance loans to such persons.[43] Thus, as under present law, a section 501(c)(3) organization that owns and operates a hospital may not finance the construction of a medical office building used in the private practice of medicine with qualified 501(c)(3) bonds.[44] Additionally, facilities financed with qualified 501(c)(3) bonds must be owned by a section 501(c)(3) organization or by (or on behalf of) a governmental unit, since, applying the same concept of use as applies to IDBs, ownership by other persons would result in violation of the 5 percent use limitation above.

As under present law, the use of bond proceeds by section 501(c)(3) organizations in unrelated trades or businesses (as determined by applying sec. 513(a)) is a nonexempt use. Thus, if more than 5 percent of the bond proceeds or of bond-financed property is used in such an unrelated trade or business, the bonds are not qualified 501(c)(3) bonds.

The committee is aware that certain State or local governmental universities and hospitals (including certain public benefit corporations) also have received determination letters regarding their tax-exempt status under Code section 501(c)(3). The committee intends that, to the extent that such an entity is a governmental unit or an agency or instrumentality of a governmental unit (determined as under present law), bonds for the entity will be treated as governmental bonds rather than as qualified 501(c)(3) bonds.

The committee understands that certain facilities eligible for financing with qualified 501(c)(3) bonds may comprise part of a larger facility otherwise ineligible for such financing or that portions of a section 501(c)(3) organization facility may be used for activities of persons other than section 501(c)(3) organizations or governmental units. The committee intends that the Treasury Department may adopt rules for allocating the costs of such mixed use facilities (including common elements) according to any reasonable method that properly reflects the proportionate benefit to be derived, directly or indirectly, by the various users of the facility. Only the portions of such mixed use facilities owned and used by

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[43] These tests are applied in the same manner as the IDB trade or business use test and the private loan bond restriction, described above.

[44] *See, e.g.*, Rev. Rul. 77-352, *supra.*, for an example of circumstances under which use of section 501(c)(3) organization facilities by other nongovernmental persons may result in the facilities being treated as used in the other person's trade or business.

section 501(c)(3) organizations may be financed with bonds for such organizations.

The committee also is aware that the conduct of basic research is an integral function of universities, and that section 501(c)(3) universities may enter into cooperative agreements with other nongovernmental persons for the conduct of such basic research.[45] The committee intends that the use of bond-financed property by a university to perform general (as opposed to product development) research supported or sponsored by such other persons pursuant to a cooperative research arrangement is not to be treated as trade or business use by such persons, nor is the research support to be considered direct or indirect repayment of the bonds, provided that any agreed use of any resulting technology by the nonuniversity sponsoring person is permitted only on the same terms by which the university permits such use by any other nonsponsoring unrelated party. Thus, a cooperative research agreement which provides for a license of any resulting technology at a royalty rate fixed in advance of the performance of the research could constitute such a trade or business use; however, an agreement with only a first right of refusal (at a competitive price) for the sponsoring person would not constitute such a use.

Restriction on term to maturity

The bill extends the present-law rule under which the term of IDBs may not exceed 120 percent of the economic life of the property financed to qualified 501(c)(3) bonds. Subject to exceptions for certain pooled financings, and for mortgage loans insured under certain FHA insurance programs, this rule is applied to qualified 501(c)(3) bonds in the same manner as to IDBs. In the case of qualified 501(c)(3) bonds 95 percent or more of the proceeds of which are used for pooled financings for benefit of multiple section 501(c)(3) organizations, the restriction is determined by reference to each loan to a participant in the pool. For example, if a pool participant borrowed funds for property having a 10-year ADR midpoint, the maximum term of the loan permitted to the participant would be 12 years. If the participant borrowed funds for more than one property, a weighted average economic life would be used.

Student loan bonds

The bill continues the tax-exemption for interest on qualified student loan bonds, defined as under present law. These bonds include bonds issued by qualified governmental units or by qualified scholarship funding corporations in connection with GSL and PLUS programs of the United States Department of Education.

The bill also expands the definition of qualified student loan bond to include obligations to make or finance loans under certain State supplemental loan programs. Programs qualifying for this financing include any program of general application approved by the State to which part B of title IV of the Higher Education Act of

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[45] State and other governmental universities may enter into similar arrangements. The determination of whether such an arrangement involves a use in a trade or business of a person other than the university is the same for State or other governmental universities as for universities that are section 501(c)(3) organizations.

1965 (relating to guaranteed student loans) does not apply, if loans under the program are limited to the difference between (1) the total cost of attendance and (2) other forms of student assistance. For purposes of determining other forms of student assistance, loans made pursuant to section 428B(a)(1) of the Higher Education Act of 1965 (relating to parent loans), and loans made pursuant to subpart C.I of Title VII of the Public Health Service Act (relating to certain student assistance), are not taken into account.

3. State volume limitations applicable to certain bonds

The bill retains the three separate sets of volume limitations that apply under present law to (1) most IDBs and all student loan bonds, (2) qualified veterans' mortgage bonds, and (3) qualified mortgage bonds. Additionally, the bill retains the presently scheduled reduction in the IDB and student loan bond volume limitation to $100 per capita, after December 31, 1986.

Certain bonds are not subject to volume limitations under the bill. First, qualified 501(c)(3) bonds are not subject to State volume limitations. Second, IDBs to finance multifamily residential rental property are not subject to State volume limitations. Third, IDBs to finance governmentally owned, but privately used airports, docks and wharves, and sewage, solid waste disposal, and water facilities are not subject to State volume limitations.

The bill provides a special rule for determining when property is governmentally owned for purposes of this exception from the volume limitations on IDBs. Under this safe harbor, airports, docks and wharves, sewage and solid waste disposal facilities, and water facilities are treated as governmentally owned if (1) no person other than a governmental unit is entitled to use of the facility for a period exceeding 80 percent of the useful life of the facility (including renewal periods); (2) no such person is entitled to purchase the facility for other than fair market value and, (3) no such person is entitled to claim cost recovery deductions or any tax credit with respect to the property (either under the general provisions of the bill or under any transitional exception in the bill).

In applying these rules, use by a nongovernmental person pursuant to any arrangements permitting use on a basis different from that available to the public generally, e.g., a lease, a management or service contract, or other arrangement granting special rights, are considered.

4. Arbitrage restrictions

The bill makes numerous technical amendments to the general arbitrage restrictions applicable to all tax-exempt bonds; extends to all tax-exempt bonds both (1) a requirement that certain arbitrage profits be rebated to the Federal Government and (2) a limitation on the amount of bond proceeds that may be invested in nonpurpose obligations; and restricts advance refundings.

General arbitrage restrictions applicable to all bonds

Modification of minor portion rule

The bill modifies the rule that a minor portion (15 percent) of bond proceeds may be invested in materially higher yielding obliga-

tions. The present-law exception for reasonably required reserve and replacement funds is retained, but, unlike present law, such reserve funds are not treated as part of the allowable minor portion. Instead, the minor portion is limited to an amount of bond proceeds not exceeding the lesser of five percent of the proceeds or $100,000, determined without reference to any reasonably required reserve fund.

The present-law definitions of materially higher yield are not modified. Thus, under the bill, permissible arbitrage profits generally are limited to 0.125 percentage points (plus certain costs if the investments are acquired purpose obligations) above the yield on the bond issue. In the case of acquired program obligations, the present-law limit of 1.5 percentage points (plus certain costs) continues to apply.

Expansion of investments subject to arbitrage restrictions (including annuities to fund pension plans)

The bill also expands the types of obligations to which the arbitrage restrictions apply.[47] Under the bill, the arbitrage restrictions are expanded to apply to the acquisition of any property held for investment (other than another bond exempt from tax under the Code). Thus, investment in any taxable security or obligation as well as any deferred payment contract (e.g., an annuity) or other property held for investment is prohibited if the yield on the property is materially higher than the yield on the bonds. This restriction applies regardless of the purpose of the investment (e.g., whether the investment is acquired as an acquired purpose obligation, an acquired nonpurpose obligation, or an acquired program obligation).

Under this rule, for example, the purchase of an annuity contract to fund a pension plan of a qualified governmental unit is subject to the same arbitrage restrictions as direct funding of that plan with bond proceeds. Investment of bond proceeds in any other type of deferred payment investment-type contract to fund an obligation of the issuer or bond beneficiary also is subject to these yield restrictions. The restriction does not apply, however, to real or tangible property acquired with bond proceeds for reasons other than investment (e.g., courthouse facilities financed with bond proceeds).

Clarification of reasonable expectations test

The bill codifies the application of the present-law reasonable expectations test as it applies to subsequent deliberate and intentional acts to earn arbitrage. As under present law, the determination of whether bonds are arbitrage bonds generally is based upon the reasonable expectations of the issuer on the date of issue. If subsequent deliberate and intentional acts are taken after the date of issue to produce arbitrage, however, the reasonable expectations test will not prevent the bonds from being arbitrage bonds. (*See, e.g.*, Rev. Rul. 80-91, 1980-1 C.B. 29, Rev. Rul. 80-92, 1980-1 C.B. 31, Rev. Rul. 80-188, 1980-2 C.B. 47, and Rev. Rul. 85-182, 1985-46 I.R.B. 4 (Nov. 4, 1985).).

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[47] Section 648 of the Deficit Reduction Act of 1984 provides that, in certain cases, property held in the Permanent University Fund of the University of Texas and Texas A&M University is not treated as an investment of bond proceeds for purposes of the Code arbitrage restrictions. The bill does not affect this provision regarding the Permanent University Fund.

Violation of this continuing requirement results in the bond interest becoming taxable, retroactive to the date the bonds are issued. The committee intends that the determination of whether deliberate and intentional actions to earn arbitrage have been taken is made on a case-by-case basis.[48]

Election to forego temporary periods

Under the bill, the right to elect under Treasury Department regulations to forego a temporary period during which unlimited arbitrage earnings are permitted and by doing so receive the right to earn arbitrage of 0.5 percentage points over the yield of the issue is eliminated. Thus, the definition of the term materially higher generally is limited to 0.125 percentage points over the yield on the issue.

Treatment of certain credit enhancement fees

The bill retains the present-law rules under which bond insurance premiums are treated as interest if the bond insurance results in a reduction in the interest rate on the bonds. In addition, the committee intends that the Treasury Department amend its regulations and to permit the same treatment for the costs of other credit enhancement devices (e.g., letters of credit) when the cost of the credit enhancement reflects an arm's-length transaction. To preclude deflection of arbitrage, the committee understands that the Treasury Department may restrict its regulations to credit enhancement devices purchased pursuant to competitive bidding by credit-enhancement providers.

Treasury Department regulations for student loan bonds

The bill retains the present-law direction to the Treasury Department to develop special arbitrage regulations for qualified student loan bonds, to the extent that this direction is consistent with the restrictions included in the bill. These regulations, when adopted, will be effective as provided in the 1984 Act.

Determination of bond yield

The bill provides that, under all arbitrage restrictions applicable to tax-exempt bonds, the yield on an issue is determined based on the issue price, taking into account the Code rules on original issue discount and discounts on debt instruments issued for property (secs. 1273 and 1274). This amendment reverses the holding in the case *State of Washington* v. *Commissioner, supra.*

Extension of additional arbitrage restrictions to most tax-exempt bonds

The bill generally extends to all tax-exempt bonds (including refunding issues) additional arbitrage restrictions similar to those presently applicable to most IDBs and to qualified mortgage bonds. These restrictions, requiring the rebate of certain arbitrage profits and limiting investment of bond proceeds in nonpurpose obligations, are in addition to the general arbitrage restrictions for all tax-exempt bonds.

[48] Although the amended arbitrage rules generally apply only to bonds issued after the date of the bill's enactment, no inference is intended that such subsequent deliberate and intentional actions to earn arbitrage profits are permitted under present law.

Limited exceptions are provided to the requirement that arbitrage profits be rebated to the Federal Government for bonds issued to finance operations of certain small governmental units with general taxing powers, for certain debt service funds of governmental units with general taxing powers, and for certain arbitrage profits on student loan bonds issued in connection with the Federal GSL and PLUS programs. The bill further directs the Treasury Department to modify its SLGS program to eliminate any administrative difficulties that may arise in connection with the expanded rebate requirement.

Requirement of rebate for bonds other than mortgage revenue bonds

General rules.—As is currently required of most IDBs, certain arbitrage profits earned on nonpurpose obligations acquired with the gross proceeds of all tax-exempt bonds generally must be rebated to the United States. Nonpurpose obligations include all obligations other than those specifically acquired to carry out the governmental purpose for which the bonds are issued. Obligations invested in a debt service reserve fund or in an escrow established with proceeds of a refunding issue are considered to be nonpurpose obligations.

Gross proceeds are the total proceeds of an issue, including the original proceeds of the bonds, the investment return on obligations acquired with the bond proceeds (including repayment of principal), and amounts used or available to pay debt service on the issue. The committee intends that the term gross proceeds be interpreted broadly, as under the present-law general and additional IDB arbitrage restrictions.

Arbitrage profits that must be rebated include (1) the excess of the aggregate amount earned on all nonpurpose obligations (other than income earned on the arbitrage itself) over the amount that would have been earned if all nonpurpose obligations were invested at a yield equal to the yield on the issue, plus (2) any income earned on the arbitrage. The yield on the issue is determined based on the issue price, taking into account the Code rules on original issue discount and discounts on debt instruments issued for property (secs. 1273 and 1274).

The committee is aware that qualified governmental units frequently commingle bond proceeds with tax and other revenues during temporary periods when unlimited arbitrage on the bonds is permitted. This commingling differs from practices used in connection with most financing for nongovernmental persons. In general, the rebate requirement of the bill requires separate accounting for bond proceeds, since issuers must rebate arbitrage regardless of whether the bond proceeds are commingled with other amounts. The committee intends, however, that the Treasury Department may prescribe simplified methods of accounting for governmental bond proceeds where requiring separate accounting otherwise would result in undue hardship. (This is distinct from the exception for certain small governmental issues, discussed below.)

Exceptions to requirement of rebate.—The rebate requirement does not apply to an issue if all gross proceeds of the issue are expended within six months of the issue date for the governmental purpose for which the bonds are issued. In the case of bonds issued

as part of a series (i.e., a series of refundings) only one six-month period is allowed; that period begins on the date on which the first bond in the series is issued. Similarly, only one six-month period is available with respect to a single issue of bonds where more than one draw-down of proceeds is anticipated or occurs.

Also as under present law, a second exception is provided for certain temporary investments related to debt service. Under this exception, if less than $100,000 is earned on a bona fide debt service fund in a bond year with respect to an issue, arbitrage earned on the fund in that year is not subject to the rebate requirement, unless the issuer elects to consider such amount when determining the amount of the rebate otherwise due with respect to the issue. This election must be made at the time of, or before, issuance of the bonds, and the election, once made, is irrevocable. In the case of governmental units with general taxing powers, the $100,000 limitation on earnings on bona fide debt service funds does not apply.

A third exception applies in the case of bonds to finance operations of certain small governmental units with general taxing powers. A small governmental unit is defined as a unit that reasonably expects to issue $5 million or less in tax-exempt bonds in the calendar year in which the bonds to which this exception applies are issued. Only governmental bonds (i.e., bonds other than IDBs, mortgage revenue bonds, student loan bonds, qualified 501(c)(3) bonds, other private loan bonds for which tax-exemption is permitted or non-Code bonds that are in substance any of the foregoing) may be exempt from the rebate requirement under this exception. In determining whether the $5 million limit has been exceeded, however, all bonds issued by or on behalf of the issuing governmental unit are counted. Thus, if a governmental unit having general taxing powers reasonably expected to issue $3 million in bonds to fund its operations in a year, but an industrial development authority issuing bonds on behalf of the governmental unit reasonably expected to issue $10 million in bonds, this exception from the rebate requirement would not be available.

A fourth exception from the rebate requirement is provided for arbitrage profits earned on proceeds of qualified student loan bonds issued in connection with the Department of Education's GSL and PLUS programs during initial temporary periods when issuers are permitted to earn such profits without regard to yield restrictions. Under this exception, for example, issuers of these student loan bonds may retain arbitrage profits earned during an initial temporary period permitted under Treasury regulations and use those profits to defray costs of issuance and administrative costs of the student loan bond agency to the extent those costs are not reimbursed by student borrowers.

Limitation on loss of tax-exemption for certain failures to rebate—The bill provides that a special penalty, in lieu of loss of tax-exemption, applies to certain failures to rebate arbitrage profits in the case of governmental bonds and qualified 501(c)(3) bonds. Under this rule, issuers are liable for a penalty equal to 100 percent of any amount not rebated when due. The penalty may be waived by the Treasury Department if the error is due to inadvertence on the part of the issuer.

If an issuer corrects any underpayment (and pays any penalty due) within six months of being notified by the Treasury Department, the bonds do not become taxable (assuming no willful disregard of the rebate requirements). If the issuer fails to pay all amounts due within this six-month period or acts in willful disregard of the rebate requirement, the bonds are taxable retroactive to the date of issuance.

Requirement of rebate of certain arbitrage profits in the case of mortgage revenue bonds

The bill retains the provisions of present law that require either crediting of certain arbitrage profits on qualified mortgage bonds to mortgagors or rebate of those earnings to the Federal Government. In addition, the bill extends these arbitrage restrictions to qualified veterans' mortgage bonds. These rebate rules apply in lieu of the rebate requirements like those that currently apply to IDBs.

Restriction on investment in nonpurpose obligations for all tax-exempt bonds

In addition to the rebate requirement, the Act extends to all bonds not presently subject to the requirement (i.e., bonds other than most IDBs and qualified mortgage bonds) a limitation on the amount of bond proceeds that may be invested in nonpurpose obligations. This restriction does not apply to proceeds of advance refunding bonds to be used to discharge the refunded bonds. Under the bill, the amount of proceeds that may be so invested at a yield above the bond yield at any time during a bond year is limited to 150 percent of the debt service for the bond year. These investments must be reduced as the bond issue is repaid. This restriction does not apply to amounts invested for the initial temporary periods during which unlimited arbitrage profits may be earned and for temporary periods related to current debt service. (The rebate requirement does apply, however, to such amounts if the gross proceeds are not expended for the governmental purpose of the borrowing within six months.)

For purposes of this restriction, debt service includes interest and amortization of principal scheduled to be paid with respect to an issue for the bond year, but does not include payments with respect to bonds that are retired before the beginning of the bond year. This restriction does not, however, require the sale or other disposition of any investment if that disposition would result in a loss that exceeds the amount that otherwise would be paid to the United States assuming a payment was due at that time.

Modification of SLGS program

The bill directs the Treasury Department to modify the operation of its current State and Local Government Series (SLGS) program to allow more flexible investment of bond proceeds in order to eliminate the need for rebating arbitrage profits on tax-exempt bonds. Specifically, Treasury is to eliminate any advance notice requirements for the purchase of SLGS and any minimum required term for those obligations. The committee intends that the program will operate in much the same manner as a privately managed mutual fund.

The changes in the SLGS program are to be designed to ensure that the program operates at no overall net cost to the Federal Government. Specifically, the interest rate paid on SLGS is to reflect an after-tax cost of borrowing on taxable Federal obligations of a comparable maturity to SLGS issued under the revised program, and Treasury is to recoup the costs of operating the program, either through adjustment of interest rates on SLGS or through borrower fees.

5. Restrictions on advance refundings

The bill extends the present-law prohibition on advance refundings of IDBs and mortgage revenue bonds to student loan bonds, other private loan bonds for which tax-exemption is permitted under the Code, and non-Code bonds comparable to any of these bonds. Thus, only bonds to finance government operations and section 501(c)(3) organization bonds may be advance refunded under the bill.[49] A refunding is an advance refunding in any case where the refunded bonds are not redeemed (e.g., called in such a manner that no further interest accrues on the bonds) within 90 days after the refunding bonds are issued.

When permitted, advance refundings are subject to the following restrictions:

(1) Each original bond may be advance refunded no more than three times;

(2) No more than three sets of bonds (including the original bonds and any refunding bonds) may be outstanding at any one time;

(3) The initial temporary period during which unlimited arbitrage profits may be earned on any issue of advance refunding bonds expires no later than 30 days after the date of its issuance, and on any issue of refunded bonds, no later than the date of issuance of the refunding bonds; and

(4) In the case of an issue of advance refunding bonds that may produce a present-value debt service savings (determined without regard to issuance costs and administrative costs), the refunded bonds must be redeemed on the first date on which the bonds may be redeemed (i.e., the first available call date occurring more than 90 days after issuance of the refunding bonds).[50]

In addition, any advance refunding that involves the use of a "device" to obtain a material financial advantage other than savings arising from lower interest rates generally is prohibited. Thus, the use of such a device in connection with the issuance of advance refunding bonds (i.e., a so-called flip-flop or other device described in the examples below, or any other device identified in prospective Treasury Department regulations or rulings) results in interest on the advance refunding bonds being taxable from the date of their issue. This prohibition is similar to the "artifice or device" provision under present law (*see* Treas. Reg. sec. 1.103-13(j)), except that it does not require a specific finding that the transaction or series

[49] Bonds that may not be currently refunded as a result of any provision of the bill or of present law (e.g. the 1984 act) (or that may not be advance refunded under present law) may not be advance refunded under this provision.

[50] This requirement would apply, *inter alia*, to a crossover refunding of a floating rate issue.

of transactions increases the burden on the market for tax-exempt obligations. The following examples describe some of the types of transactions that are treated as devices for purposes of this provision:[51]

Example (1).—Pursuant to a transaction or series of transactions in connection with the issuance of advance refunding bonds, proceeds of the refunding bonds are allocated to amounts used to pay debt service on the refunded bonds which, absent the refunding, would have been paid with proceeds (other than proceeds in a reasonably required reserve fund) of the prior issue. Assume, for example, that proceeds of the refunding bonds are allocated to amounts used to pay the next installment of debt service on the refunded bonds. Absent the refunding, the next installment of debt service would have been paid with revenues accumulated on or before the date of issue of the refunding bonds (or capitalized interest on the refunded bonds). The method of allocation adopted by the issuer permits the issuer to allocate the revenues to amounts used to pay a later installment of debt service on the refunded bonds and to invest the revenues and the earnings thereon substantially longer than they would have been invested absent the refunding. The allocation method is a device in that it enables the issuer to obtain a material financial advantage that would not have been available if proceeds of the refunding bonds had not been allocated to amounts used to pay debt service which otherwise would have been paid with the prior issue proceeds.

Example (2).—Pursuant to a transaction or series of transactions, bonds are issued to pay project costs which were to be paid with proceeds of a prior issue, and the proceeds of the prior issue are invested in an escrow established to pay debt service on the prior issue payable in future years. The proceeds of the prior issue are invested at a materially higher yield than the yield on the bonds. Bonds issued pursuant to this transaction or series of transactions are treated as advance refunding bonds for purposes of the additional restrictions on advance refundings under the bill, and the issuer is considered to have employed a device in connection with the issuance of the refunding bonds to obtain a material financial advantage apart from savings attributable to lower interest rates.

Example (3).—A direct monetary benefit with respect to the refunded bond is achieved by reason of issuance of an advance refunding bond and is not taken into account in determining the yield on the refunding bond. For example, if an advance refunding enables the issuer to obtain a rebate of a portion of the premium paid to insure the prior issue (or results in a reduction in the interest payable on the prior issue and thus a reduction in the amount of refunding bonds needed to refund the prior issue), the issuer will be considered to have employed a device in connection with the issuance of the refunding bond to obtain a material financial advantage apart from savings attributable to lower interest rates unless the yield on the refunding bond is determined by taking the direct monetary benefit into account (i.e., as an increase in the issue price of the refunding bond).

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[51] No inference is intended as to the present-law treatment of the transactions described (or not described) in these examples.

Example (4).—Pursuant to a series of transactions, a prior issue is refunded by issuing (1) long-term advance refunding bonds (intended to be tax-exempt) to pay debt service on the prior issue in the early years, and (2) short-term advance refunding bonds (not intended to be tax-exempt) to pay debt service on the prior issue in the later years. Proceeds of the short-term advance refunding issue are invested at a yield materially higher than the yield on both the short-term and the long-term advance refunding issues. By separating the two issues, the issuer has attempted to exploit the difference between the taxable rate at which proceeds of the short-term advance refunding issue are invested and the tax-exempt rate of the long-term advance refunding issue. If a material financial advantage has been obtained by separating the two issues, the issuer has employed a device in connection with the issuance of the long-term advance refunding bonds to obtain a material financial advantage apart from savings attributable to lower interest rates.

6. Change in use of facilities financed with IDBs, mortgage revenue bonds, qualified 501(c)(3) bonds, and certain other bonds

Under present law, interest on bonds may become taxable, either retroactively to the date of issue or (if specifically provided in the Code) prospectively, if certain events occur. The bill provides that, in addition to any loss of tax-exemption provided under present law, certain expenditures by nongovernmental persons using property financed with IDBs, mortgage revenue bonds, qualified 501(c)(3) bonds, and other private loan bonds for which tax-exemption is permitted are nondeductible for Federal income tax purposes in certain circumstances. Under this provision, interest (including the interest element of user fees) becomes nondeductible if property financed with the proceeds of these bonds is used in a manner not qualifying for tax-exempt financing at any time before the bonds are redeemed.[52] The interest or other user charges are nondeductible, effective from the first day of the year in which the change of use occurs and continue to be nondeductible until the date on which the property again is used in the use for which the bonds were issued, or the date on which the bonds are redeemed, if earlier.

Governmentally owned property

If bond-financed property is required to be governmentally owned, but ceases to be, interest (including the portion of any rent or other user charges that is treated as interest for Federal income tax purposes) paid by the new owner with respect to the property is nondeductible.

If the use of governmentally owned bond-financed property changes from a use qualifying for tax-exempt financing to a nonqualified use and a governmental unit continues to own the property, a portion of any rent or other user fee paid by the nongovernmental person using the property in the nonqualified use is nondeductible.

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[52] This requirement applies throughout the prescribed qualified project period in the case of projects for residential rental property.

The nondeductible portion is an amount of rent or other user fees equivalent to the interest payments on that portion of the bonds attributable to the portion of the facility used in a nonqualified use. For example, if a governmentally owned airport terminal were converted to a private office or retail complex, each nongovernmental user of the converted property would be denied deductions for rent and other user fees with respect to the property, to the extent of the interest payments on an allocable portion of the bonds. If the allocable bond interest payments exceed otherwise deductible rent or other user charges, the full amount of those deductions is denied.

Facilities (other than owner-occupied housing) owned by nongovernmental persons (other than section 501(c)(3) organizations)

If nongovernmentally owned bond-financed facilities are converted to a use not qualifying for such tax-exempt financing, interest on loans financed with bond proceeds becomes nondeductible. This restriction applies in the case of a change in ownership accompanied by a change in use as well as a change in use where the same person continues to own the property for Federal income tax purposes.[53] The bill provides a special rule for multifamily residential rental projects that fail to meet the 20- or 25-percent low- or moderate-income occupancy requirements applicable to such projects, or which otherwise cease to be used in a manner qualifying for tax-exempt financing. Under this special rule, the owners of the project are denied interest deductions with respect to bond-financed loans. However, as under the present-law rules on loss of tax-exemption, if post-issuance noncompliance is corrected within a specified period after it is discovered or reasonably should have been discovered, there is no loss of deductions. (See, the section on IDBs for multifamily residential rental property, above, for a more complete discussion of this exception.)

Mortgage revenue bond-financed housing

If a residence financed with qualified mortgage bonds or qualified veterans' mortgage bonds ceases to be the principal residence of at least one of the mortgagors for a continuous period of 1 year or more, the mortgagors are denied a deduction for interest paid with respect to the bond-financed mortgage loan on the residence. For purposes of these rules, the term principal residence has the same meaning as under section 1034 of the Code (regarding nonrecognition of gain on the sale of a principal residence).

The Treasury Department is authorized to waive this penalty in cases where undue hardship otherwise would result and the noncompliance arises from circumstances beyond the control of the mortgagors (e.g., a residence occupied by minor children of a deceased mortgagor).

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[53] A change in use of property financed with small-issue bonds is deemed to occur if post-issuance capital expenditures test result in the $10 million small-issue size limitation being violated. Similarly, a change in use to a use specifically prohibited under the Code results in application of these penalties, including such a change in use of facilities located on land with respect to which qualified redevelopment bond financing was provided.

The committee further is aware that certain housing comprised of fewer than five units, one of which is occupied by the owner, is treated as single-family housing under the qualified mortgage bond rules. In the case of such housing, whether the owner uses the property as his or her principal residence is determined by reference to use of the owner-occupied unit (or units).

Qualified 501(c)(3) bond-financed property

If the use of property financed with qualified 501(c)(3) bonds changes to a use not qualified for such financing (at the time the bonds were issued), the section 501(c)(3) organization benefiting from the bonds is treated as using the property in an unrelated trade or business (see, sec. 511) from the first day of the year in which the change in use occurs. Interest on the bond-financed loans is treated as incurred in that unrelated trade or business and is nondeductible against any income of the business.

In the case of a change in ownership of section 501(c)(3) property (other than a transfer to a qualified governmental unit or another section 501(c)(3) organization), the new owner of the property is denied deductions for interest (including all amounts treated as interest for Federal income tax purposes) incurred in connection with the acquisition of the property.

Proportionate disallowance in the case of partial change in use

The Treasury Department is authorized to prescribe regulations for allocating interest on bond-financed loans in the case of a change in use (or ownership) of only a portion of a facility (or a portion of the facilities financed by an issue). In the case of partial changes in use (including a change in ownership) where an interest element is imputed as a portion of another user fee (e.g., rent), the maximum amount treated as nondeductible will be the amount of the rent or other user fee. In general, the committee anticipates that these regulations will provide that interest is allocated proportionately to all users of the facility based upon factors such as relative cost, floor space occupied, relative rental value, or another comparable method. In making this allocation, each user (owner) is treated as the sole user (owner) of all common elements of a facility.

7. Cost recovery deductions for bond-financed property

The bill provides that tax-exempt bond-financed property for which nongovernmental ownership is permitted is not generally eligible for full cost recovery deductions. This limitation applies both to the first owner of the property and to any subsequent owners who acquire the property while the bonds (including any refunding issues) are outstanding.

The cost of property financed with tax-exempt bonds generally is recovered using the recovery methods and periods prescribed for tax-exempt use property. Thus, the straight-line method is used and the recovery period is equal to the ADR midpoint life of the property (40 years for real property).

Three exceptions are provided to these extended recovery periods, but not to the requirement that the straight-line method be

used. The cost of bond-financed solid waste disposal facilities and hazardous waste treatment facilities may be recovered over an eight-year period. Additionally, the cost of bond-financed multifamily residential rental property may be recovered using a 27½-year recovery period, the same recovery period as is prescribed for residential real property generally.

8. Information reporting for all bonds

The bill extends to all bonds on which interest is tax-exempt information reporting requirements similar to those that apply under present law to IDBs, qualified mortgage bonds, qualified veterans' mortgage bonds, student loan bonds, and section 501(c)(3) organization bonds. In general, the information required to be reported to the Treasury Department is similar to that required under present law. The committee recognizes, however, that certain information required under present law with respect to IDBs and mortgage bonds will be inapplicable in the case of bonds for general government operations because governmental bonds are not issued exclusively to finance specific facilities. The bill, therefore, authorizes the Treasury to vary the specific information that is required with respect to facility, and non-facility, bonds.

The committee understands that obligations issued to finance activities of governmental units may be issued in small amounts in some cases, and that requiring a separate information report for each issue might involve undue hardship. The committee intends that the Treasury Department may, in certain cases, permit issuers to file a simplified consolidated report for issues of such obligations.

Effective Dates

Industrial development bonds

General definition

The amendments to the definition of industrial development bonds generally are effective for bonds (including refunding bonds) issued after the date of enactment of the bill. A transitional exception is provided for bonds (other than refunding bonds) with respect to facilities—

(1) the original use of which commences with the taxpayer and the construction (including reconstruction or rehabilitation) of which began on or before March 1, 1986, and was completed after that date;

(2) the original use of which commences with the taxpayer and with respect to which a binding contract to incur significant expenditures for construction (including reconstruction or rehabilitation) of facilities financed with the bonds was entered into on or before March 1, 1986, was binding at all times thereafter, and part or all of such expenditures were incurred after that date; or

(3) acquired after March 1, 1986, pursuant to a binding contract entered into on or before that date and that is binding at all times after March 1, 1986.

This transitional exception applies only to bonds for facilities for which the bond financing in question was approved by a qualified

governmental unit (or by voter referendum) on or before March 1, 1986. Governmental approval for this purpose includes approval by means of an inducement resolution or, if the qualified governmental unit does not generally adopt inducement resolutions for the type of bond concerned, other comparable approval.

For purposes of the binding contract rule described in (2) above, significant expenditures means expenditures in excess of 10 percent of the reasonably anticipated cost of the facilities.

Whether or not an arrangement constitutes a contract is to be determined under the applicable local law. A binding contract is not considered to have existed on or before March 1, 1986, however, unless the property to be acquired or services to be rendered were specifically identified or described before that date.

A binding contract for purposes of this provision exists only with respect to property or services for which the taxpayer is obligated to pay under the contract. In addition, where a contract obligates a taxpayer to purchase a specified number of articles and also grants an option to purchase additional articles, the contract is binding only to the extent of the articles that must be purchased.

A contract may be considered binding on a person even though (1) the contract contains conditions the occurrence of which are under the control of a person not a party to the contract, or (2) the person has the right under the contract to make minor modifications as to the details of the subject matter of the contract.

A contract that was binding on March 1, 1986, will not be considered binding at all times thereafter if it is modified (other than as described in (2) above) after that date. Additionally, for purposes of the binding contract exception, payments under an installment payment agreement are incurred no later than the date on which the property that is the subject of the contract is delivered (rather than the due date of each installment).

The bill also provides a transitional exception with respect to certain current refunding bonds.[54] Refundings qualifying for this exception[55] are refundings of bonds (including a series of refundings where the original bond was issued before that date) that were issued before the date of enactment. Refunding bonds qualify under this transitional exception only if—

(1) the amount of the refunding bonds does not exceed the outstanding amount of the refunded bonds, and

(2) either (a) the issue of refunding bonds (or series of refundings) satisfies the maturity limitation that applies under present law to IDBs, or (b) the last maturity date of the refunding bond is no later than 17 years after issuance of the refunded (original) bonds.

Exempt-activity IDBs

The provisions deleting certain types of bonds from the list of facilities for which exempt activity IDBs and redefining or retargeting other, continued, types of facilities may be issued apply to bonds issued after the date of the bill's enactment. Transitional ex-

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[54] Advance refunding bonds, as defined under the bill, may not be issued under this transitional exception. (A separate transition rule is provided with respect to advance refundings of certain pre-effective date bonds).

[55] This rule does not change the present-law rules under which various types of bonds that were prohibited or restricted under the Deficit Reduction Act of 1984 may not be refunded.

ceptions like those provided for the redefinition of IDB, above, are provided with respect to these amendments.[56]

The addition of an exception for IDBs for hazardous waste treatment facilities applies to bonds issued after the date of the bill's enactment.

Industrial park IDBs

The repeal of tax-exemption for industrial park IDBs applies to bonds issued after the date of enactment, subject to transitional exceptions like those provided for the redefinition of IDB.

Qualified redevelopment IDBs

The addition of an exception for qualified redevelopment IDBs applies to bonds issued after the date of the bill's enactment.

Small-issue IDBs

The amendments to the small-issue exception, other than the limitation on financing depreciable farm property, apply to bonds issued after the date of the bill's enactment.

The restriction on tax-exempt financing for depreciable property used in farming applies to bonds issued after April 17, 1986.

95 percent use requirement

The requirement that at least 95 percent of IDB proceeds be used for the purpose of the borrowing applies to bonds issued after the date of the bill's enactment. A special transitional exception like that under the amendments to the general definition of IDB (i.e., projects under construction or certain binding contracts) is provided for solid waste disposal facilities.

Mortgage revenue bonds and mortgage credit certificates

The retitling of mortgage subsidy bonds as mortgage revenue bonds is effective on the date of the bill's enactment. The increase in the MCC credit trade-in rate, from 20 to 25 percent, applies to credits issued using bond authority for years after 1986 exchanged after December 31, 1986.

The provision allowing limited equity housing cooperatives to elect to be treated as rental housing is effective for bonds issued after the date of enactment.

Qualified 501(c)(3) bonds

The provision limiting to no more than 5 percent the amount of the proceeds of qualified 501(c)(3) bonds that may be used by nonexempt purposes, and the other amendments affecting these bonds, are effective for bonds issued after the date of the bill's enactment.

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[56] For purposes of this rule, and the remaining transition rules discussed below, the determination of whether original use commences with the taxpayer; or whether construction (including reconstruction or rehabilitation) or acquisition, began before (and was completed on or after) a specified date; of whether significant expenditures were made; and, of whether a binding contract existed is to be made in the same manner as under those provisions. Additionally, the determination of whether a facility is described in a properly adopted inducement resolution (or other comparable approval) is to be made in the same manner as described above.

Student loan bonds

The expansion of tax exemption for interest on student loan bonds to certain State supplemental student loan bonds applies to bonds issued after the date of enactment.

Unrelated use restriction

The provision restricting the amount of proceeds of governmental bonds that may be used in trade or business uses unrelated to governmental facilities also being financed with the bonds applies to bonds issued after the date of enactment. Transitional exceptions provided for the redefinition of IDB, above, are also provided with respect to this amendment.

Amendments to volume limitations

The modifications to the exceptions from the private activity bond volume limitation apply to bonds for airports, docks and wharves, sewage and solid waste disposal, and water facilities which are issued after the date of the bill's enactment. Transitional exceptions are provided for certain airport, dock and wharf, and solid waste disposal facility bonds, under the same conditions as apply to the definition of IDB, discussed above. Airport, dock, and wharf bonds covered by these transitional exceptions will remain subject to the present law tests for determining governmental ownership for volume limitation purposes. Solid waste disposal facility bonds covered by these exceptions will be eligible for a volume cap exception if issued after the date of enactment, but will be subject to the present-law tests for determining governmental ownership.

The inclusion of all hazardous waste treatment IDBs, qualified redevelopment bonds and supplemental student loan bonds in the private activity bond volume limitation applies to bonds issued after the date of enactment. (This includes all such bonds which may be issued pursuant to the bill.)

Arbitrage restrictions

The amendments to the arbitrage restrictions, including but not limited to the arbitrage rebate requirement and the restriction on investment in nonpurpose obligations, generally apply to all bonds issued after the date of enactment.

The restriction on investment of bond proceeds in annuities and similar deferred compensation arrangements purchased from third parties applies to bonds issued after September 25, 1985. The expansion of the profit limitation rules to cover other forms of investment property (i.e., except for third-party annuities and similar arrangements) applies to bonds issued after the date of the bill's enactment, together with the remaining arbitrage amendments.

The provision directing the Treasury Department to modify the SLGS program is effective on the date of the bill's enactment. This provision requires the modified program to be implemented by January 1, 1987.

Advance refunding

The limitations on advance refundings apply to advance refunding bonds issued after the date of enactment. A special transitional

exception applies to advance refunding of certain tax-exempt governmental and 501(c)(3) organization bonds which could not be originally issued under the bill, subject to the new advance refunding, and certain other, restrictions.

Another special transitional exception permits one additional advance refunding of any issue of bonds that (1) may be advance refunded under the bill and (2) have been advance refunded three or more times before the date of the bill's enactment.

Changes in use

The new penalties for changes in use of bond-financed property to a use not qualifying for tax-exempt financing apply to changes in use occurring after the date of enactment, with respect to property for which financing is provided after that date. As described in the *Explanation of Provisions*, these penalties are in addition to loss of tax-exemption for bond interest, where provided under present law.

Cost recovery for bond-financed property

The provision restricting cost recovery deductions for property financed with tax-exempt bonds applies to property placed in service after the date of enactment, if such property is financed by the proceeds of bonds issued after March 1, 1986. However, the restrictions on cost recovery deductions do not apply to property placed in service after the date of the bill's enactment if the commencement of construction or binding contract transitional rules described in the discussion of effective dates for the new rules regarding the general definition of IDBs are satisfied.

The restrictions on cost recovery deductions for bond-financed property do not apply to property placed in service after the date of the bill's enactment, if the property is financed with tax-exempt bonds issued before March 2, 1986. Cost recovery deductions for such property may be determined, however, under the new cost recovery rules generally provided by the bill. For purposes of this exception, a refunding issue after March 1, 1986 generally is treated as a new issue and the taxpayer must use the slower recovery methods and periods for costs that are unrecovered on the date of the refunding issue. No retroactive adjustments to cost recovery deductions previously claimed are required when a pre-March 2, 1986, bond issue is refunded and no significant expenditures are made with respect to the facility after the date of enactment.

Information reporting requirement

The requirement that issuers report certain information to the Treasury Department with respect to tax-exempt bonds applies to all bonds issued after the date of the bill's enactment.

Certain project-specific transitional exceptions

Certain transitional exceptions provided in the 1984 Act are re-enacted by the bill. These transitional exceptions are those exempting a specifically described project, or limited group of such projects, from one or more provisions of that Act. The bill further provides that the 1984 Act transitional exceptions re-enacted by

the bill are retained only if all transitional bonds are issued before 1988.

The bill also provides several transitional exceptions for specifically described facilities. Each of these additional transitional exceptions applies only to the one described project or issue of bonds or to a limited group of described projects and each is subject to a maximum dollar amount. Additionally, these rules generally require that the transitioned bonds be issued before 1992.

Revenue Effect

These provisions are estimated to decrease fiscal year budget receipts by $25 million in 1987, $143 million in 1988, $353 million in 1989, $533 million in 1990, and $637 million in 1991.

B. General Stock Ownership Corporations (GSOCs)

(Sec. 1517 and 1518 of the bill and secs. 1391–1397, 172(b), 3402(r), 1016(a), and 6039B of the Code)

Present Law

A State may establish a General Stock Ownership Corporation (GSOC) for the benefit of all of its citizens. The GSOC may borrow money to invest in business enterprises, and subsequently service and repay the loan from the cash flow from business operations and distribute the remaining cash to its shareholders.

In order to be treated as a GSOC, a corporation must meet certain statutory tests. First, the corporation must be chartered by an official act of the State legislature or by a Statewide referendum. Second, the charter must provide for the issuance of only one class of stock, issuable only to eligible individuals (who must be residents of the State and who satisfy other specified requirements), and for the issue of at least one share to each eligible individual; transfer rights are limited. Third, a GSOC must not be empowered to invest in properties acquired by it or for its benefit through the right of eminent domain. Fourth, a GSOC may not be affiliated with any other corporation; a 20-percent ownership test is used to determine affiliated status. Fifth, a GSOC must be organized after December 31, 1978, and before January 1, 1984.

A GSOC is exempt from Federal income tax, if it meets the statutory requirements and makes an appropriate election. Thus, a GSOC may serve as a conduit passing its taxable income through to shareholders who would be taxed on their daily pro rata share of the GSOC's taxable income.

Reasons for Change

No GSOC has been organized since enactment of the authorizing legislation, and the period during which a GSOC could be formed has expired.

Explanation of Provision

The provision authorizing creation of GSOCs is repealed as dead-wood, effective on January 1, 1984.

Revenue Effect

This provision has no revenue effect.

TITLE XVI—UNEARNED INCOME OF MINOR CHILDREN; TRUSTS AND ESTATES; ESTATE AND GIFT TAXES

A. Unearned Income of Minor Children (sec. 1601 of the bill and sec. 1 of the Code)

Present Law

The Federal income tax liability of a minor child having gross income generally is computed in the same manner as that of an adult. Thus, a minor child is allowed a personal exemption ($1,080 for 1986) and the applicable zero bracket amount (ZBA) ($2,480 for a single person for 1986). The ZBA is limited to the child's earned income if the child may be claimed as a dependent by another taxpayer.

Reasons for Change

The committee believes that the present law rules governing the taxation of minor children provide inappropriate tax incentives to shift income-producing assets among family members. In particular, the committee is aware that the treatment of a child as a separate taxpayer encourages parents whose income would otherwise be taxed at a high marginal rate bracket to transfer income-producing property to a child to ensure that the income is taxed at the child's lower marginal rates. In order to reduce the opportunities for tax avoidance through intra-family transfers of income producing property, the committee concluded that it is generally appropriate to tax the income on property transferred from a parent to a minor child at the parent's marginal rates.

Explanation of Provision

Overview

The bill establishes special rules for the taxation of income of a minor child. If a minor child has income derived from property transferred from a parent (parental-source unearned income), the bill taxes the parental source unearned income to the child at the parents' marginal tax rate. The child's earned income and nonparental-source unearned income (i.e., income derived from property that is a qualified segregated asset) is taxed to the child at the child's marginal tax rates.

Property eligible to be treated as a qualified segregated asset includes earned income, money or property received from someone other than a parent or stepparent, and property received by reason of the death of a parent. No other amounts received directly or indirectly from a parent or stepparent may be treated as qualified segregated assets.

Scope of provision

Under the bill, the special rules for taxation of a minor child's parental-source unearned income apply to any child who has not attained 14 years of age before the close of the taxable year and who has at least one living parent. Children who have attained age 14 are not subject to these special rules.[1]

Calculation of income taxable at the parents' marginal rate

Under the bill, the tax imposed on an eligible minor child with more than $100 of income is equal to the greater of (1) the tax that would be imposed on the child's income without regard to the special rules on the taxation of parental source unearned income, or (2) the sum of (a) the tax that would be imposed if the taxable income of the child for the taxable year were reduced by the child's net parental-source unearned income, and (b) the child's share of the "parental-source tax."

"Parental-source unearned income" means that portion of gross income that is not earned income (within the meaning of sec. 911(d)(2)) and is not income derived from a qualified segregated asset. All unearned income of a child is treated as parental-source unearned income unless the income is derived from a qualified segregated asset. Net parental-source unearned income is the excess of parental-source unearned income over deductions allowed for the taxable year that are directly connected with the production of such income. Under the bill, net parental source unearned income for any taxable year is not to exceed the individual's taxable income for the year.

The term "parental source tax" refers to the excess of (1) the tax that would be imposed on the parent's taxable income if that income included net parental source unearned income of each child under age 14, over (2) the tax actually imposed on the parent's taxable income. The child's share of any parental source tax is equal to an amount that bears the same ratio to the total parental source tax as the child's net parental source unearned income bears to the sum of the parental source unearned income of each child of such parent under age 14.

The bill provides that, in the case of divorced parents, the parent whose income will be taken into account for purposes of computing the tax on the child's income is the custodial parent of the child. In the case of married individuals filing separately, the income of the parent with the greater taxable income is taken into account. In the case of foster children, the foster parents are the parents whose income will be taken into account for purposes of computing the tax on the foster child's income.

The bill also provides that net parental source unearned income is not to be taken into account by a parent, in computing any deduction or credit that the parent may be entitled to claim. Nonetheless, in determining the additional tax that the parent would pay if the net unearned parental source income were includible

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[1] However, the limitation on the use of the standard deduction, the unavailability of the personal exemption, and the availability of the de minimis exception provided in the bill continue to apply to such a child, so long as the child is eligible to be claimed as a dependent by a parent. (See Title I.A., "Rate Structure.")

into the parent's return, the net parental source unearned income is taken into account in determining the phase-out of the lower bracket of the parent and the phase-out of the personal exemption that the parent may be eligible to claim.[2]

Qualified segregated assets

Under the bill, the term "qualified segregated asset" includes any asset entirely attributable to nonparental sources (or income from such asset) if the asset is timely identified as a qualified segregated asset.

An asset generally is considered to be derived from nonparental sources provided that it has not been received, directly or indirectly, by the child from any parent or stepparent of the child. Income derived from property received from a parent or stepparent is, for purposes of this rule, treated as property received from a parent or stepparent. However, under the bill, property received by reason of the death of a parent or stepparent is considered to be derived from nonparental sources.

The committee intends that qualified segregated assets not include assets indirectly transferred by the parents to their children. For example, if the parents of a child transfer assets to the grandparents of the child and the grandparents subsequently transfer assets to the child, those assets would be treated as parental source assets for purposes of this provision. Similarly, parental source assets include a transfer by parents of assets to a trust which distributes income to the child.

For purposes of this rule, the term "parent or stepparent" includes any parent as well as any individual who is or was a stepparent.

An asset will not be considered a qualified segregated asset unless it is identified as a qualified segregated asset no later than the due date (calculated with extensions) for the child's tax return for the taxable year in which the child acquired the asset, or, if later, the due date (calculated with extensions) for the first tax return that the tax of the child is determined by reference to his parents' income.

Assets are to be identified as qualified segregated assets in such manner as the Secretary of the Treasury shall prescribe.

Effective Date

The provision generally applies for taxable years beginning after December 31, 1986. Thus, the net parental-source unearned income of a child attributable to transfers of property (whether or not the transfer was made in trust) by parents before 1987 will be subject to tax at the marginal rate of the parents for taxable years of the child beginning after December 31, 1986.

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[2] The bill provides for the phase-out of the 15-percent rate bracket and the personal exemption for taxpayers at high income levels. (See Title I.A. "Rate Structure.")

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $64 million in 1987, $198 million in 1988, $217 million in 1989, $239 million in 1990, and $263 million in 1991.

B. Income Taxation of Trusts and Estates

1. Rate Schedule of Trusts and Estates (sec. 101 of the bill and sec. 1 of the Code)

Present Law

In general

Under present law, trusts and estates generally are treated as conduits with respect to amounts that are distributed currently and taxed as individuals with respect to amounts retained in the trust or estate. The conduit treatment is achieved by allowing the trust or estate a deduction for amounts that are distributed to beneficiaries during the taxable year to the extent of the distributable net income of the trust or estate for that taxable year. Such distributions are includible in the gross income of the beneficiaries to the extent of the distributable net income of the trust or estate. In general, the character in the hands of the beneficiary of amounts distributed by a trust or estate is the same as it was in the hands of the trust or estate.

When a trust distributes previously accumulated income to a beneficiary, the tax on that distribution is determined by special averaging rules. Under those rules (called the "accumulation distribution" or "throwback" rules), such income is taxed at the average of the top tax rates of the beneficiary during three of the previous five years, excluding the highest and lowest years.

Exemptions

Estates are entitled to a deduction, in lieu of a personal exemption, of $600. Trusts which are required to distribute all of their income currently are entitled to a deduction of $300. All other trusts are entitled to a deduction of $100.

Tax rates

Trusts and estates generally are taxed at the same rates as a married person filing a separate return. In the case of gain derived from the sale or exchange of property contributed to the trust within the preceding two years, that portion of the gain attributable to the difference between the fair market value of the property at the time it was contributed to the trust and the grantor's basis in the property is taxed at the grantor's marginal tax rates.

Accumulation distributions

Special rules (referred to as the so-called "accumulation distribution" or "throwback" rules) apply to the taxation of beneficiaries of a trust where the trust distributes amounts of income (other than capital gain) that had previously been taxed to the trust. Under these rules, the income is first increased (grossed up) by the taxes

previously paid by the trust on the distributed income. The grossed-up income is then included in the gross income of the beneficiary. A tax is then computed on the grossed-up amount by using the average top marginal rate of the beneficiary during three of the five preceding taxable years, excluding the two taxable years with the highest and lowest incomes. In determining the amount of this tax, all of the distribution is treated as ordinary income, other than distributed income that was tax-exempt income to the trust. Finally, the amount of the tax on the distribution of the previously accumulated income is the amount of this tax reduced (but not below zero) by the amount of taxes previously paid on the distributed income by the trust.

The accumulation distribution rules do not apply to distribution by estates. The accumulation distribution rules generally do not apply if the income was accumulated while the beneficiary was a minor. However, this exclusion from the accumulation distribution rules does not apply if distributions had been made of income from two other trusts, which income also had been accumulated in that same year.

In addition, if distributions from two other trusts previously had been made of income that was accumulated in the same year as the present distribution of accumulated income, the gross-up and credit otherwise provided for the taxes previously paid by the trust on the distributed income is not allowed.

In the case of distributions by a foreign trust of previously accumulated income, the exemption from the accumulation distribution rules for amounts accumulated while the beneficiary was a minor does not apply. In addition, any tax on distributions of previously accumulated income is increased by an interest charge computed at 6 percent for each year from the time the income was earned until it was distributed.

Multiple trusts

Two or more trusts are treated as one trust for Federal income tax purposes where those trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries and a principal purpose of such trusts is the avoidance of Federal income tax.

Reasons for Change

The present rules relating to the taxation of trusts and estates permit the reduction of taxation through the creation of entities that are taxed separately from the beneficiaries or grantor of the trust or estate. This result arises because any retained income of a trust or estate is taxed to the trust or estate under a separate set of rate brackets and exemptions from those of its grantor and beneficiaries.

Moreover, the present accumulation distribution rules are not adequate to prevent the avoidance of tax through the use of trusts and estates. In the case of estates, distributions of previously accumulated income are not subject to the accumulation distribution rules and are not taxed to their beneficiaries. In the case of trusts, the accumulation distribution rules permit the deferral of taxation

without any interest accruing on the deferred taxes. Moreover, the corrective effect of the accumulation distribution rules can be mitigated by making the distribution of previously accumulated income during years that the beneficiaries are in low tax brackets.

The committee believes that the tax benefits which result from the ability to split income between a trust or estate and its beneficiaries should be eliminated or significantly reduced. On the other hand, the committee believes that significant changes in the taxation of trusts and estates are unnecessary to accomplish this result. Accordingly, the bill attempts to reduce the benefits arising from the use of trusts and estates by revising the rate schedule applicable to trusts and estates so that retained income of the trust or estate will not benefit significantly from a progressive tax rate schedule that might otherwise apply. This is accomplished by reducing the amount of income that must be accumulated by a trust or estate before that income is taxed at the top marginal rate. The committee believes that these changes will significantly reduce the tax benefits inherent in the present law rules of taxing trusts and estates while still retaining the existing structure of taxing these entities.

Explanation of Provision

The bill revises the tax rate schedule applicable to trusts and estates. Under the revised rates, the first $5,000 of taxable income of trusts is taxed at 15 percent. Any taxable income of trusts in excess of $5,000 is taxed at 27 percent. In addition, the benefit of the 15 percent bracket is phased-out where the taxable income of the trust is between $13,000 and $25,000. The tax rate schedule applicable to estates is the same as that of a married person, filing separately, for the first two taxable years of the estate. The tax rate applicable to an estate after its first two taxable years is the same as the rate schedule applicable to trusts.

Effective Date

The provision applies to taxable years of both new and existing trusts and estates beginning after December 31, 1986.

Revenue Effect

The revenue effect of this provision is included with item 2, below.

2. Revision of Grantor Trust Rules (secs. 1611 and 1612 of the bill and secs. 672, 673, 674, 676, and 677 of the Code)

Present Law

Overview

Where the grantor transfers property to a trust and retains certain powers or interests over the trust, the grantor is treated as the owner of that trust for Federal income tax purposes under the so-called "grantor trust provisions." As a result, the income and deductions attributable to that trust are included directly in the grantor's taxable income. In addition, a beneficiary is treated as

the owner of a trust where the beneficiary has given up a power to revoke the trust but retains any of such powers or interests in the trust.

Reversionary interests

A grantor is treated as the owner of that portion of a trust in which he has a reversionary interest in corpus or income therefrom if the interest will or may reasonably be expected to take effect in possession or enjoyment within 10 years of the transfer to the trust. An exception is provided under which a grantor is not treated as having such a reversionary interest if the possession or enjoyment will not take effect until the death of the income beneficiary of that portion of the trust.

Power to control beneficial enjoyment

A grantor is treated as the owner of any portion of a trust over which the grantor, or a nonadverse party, without the consent of an adverse party, has the power to control the beneficial enjoyment of the corpus or income from that portion of the trust. Present law provides the following exceptions to this rule:

(1) the power to apply the income for the support of a dependent to the extent that the power is not used to apply the income for the support of the dependent;

(2) any power to control beneficial enjoyment of the principal or income that takes effect only after 10 years from the transfer to the trust or after the death of the income beneficiary;

(3) a power exercisable solely by will other than powers which affect accumulated income in the trust;

(4) a power to allocate income of corpus among charitable beneficiaries;

(5) a power to distribute corpus (a) to beneficiaries within a fixed class of beneficiaries which is subject to a reasonably definite standard or (b) to income beneficiaries where the corpus distribution is an advancement of that beneficiary's proportionate share of the trust;

(6) a power to withhold income temporarily from a beneficiary within a fixed class of beneficiaries where the withheld income must be distributed to that beneficiary or his estate or the beneficiary has a general power of appointment over that property;

(7) a power to withhold income during the disability of a beneficiary within a fixed class of beneficiaries;

(8) a power to allocate items between income and corpus;

(9) a power held by an independent trustee to spray income and corpus among a fixed class of beneficiaries; and

(10) a power to allocate income or corpus to beneficiaries within a fixed class of beneficiaries that is subject to a reasonably definite external standard.

Administrative powers

A grantor is treated as the owner of a portion of the trust with respect to which—

(1) the grantor or a nonadverse party has the power to deal with the trust for less than adequate and full consideration;

(2) the grantor or a nonadverse party has a power which enables the grantor to borrow trust income or corpus without adequate interest or without adequate security;

(3) the grantor has borrowed income or corpus of the trust and has not repaid that amount before the beginning of the taxable year, unless the loan provides for adequate interest and security and is made by an independent trustee; and

(4) the grantor has retained the power exercisable in a nonfiduciary capacity (a) to vote stock of a corporation in which the holdings of the trust and the grantor are significant from a viewpoint of voting control, (b) to control the investments of the trust in such corporations, or (c) to reacquire trust corpus by substituting other property of equivalent value.

Power to revoke

The grantor is treated as the owner of a portion of a trust where the grantor has the power to revest the title to that portion in the grantor, other than a power that cannot affect the beneficial enjoyment of the property until after 10 years from the transfer to the trust or after the death of the income beneficiary.

Income for benefit of grantor

The grantor is treated as the owner of a portion of a trust if the income from that portion is, or in the discretion of the grantor or a nonadverse party may be, (1) distributed to the grantor or the grantor's spouse, (2) held for future distribution to the grantor or the grantor's spouse, or (3) applied to the payment of premiums on life insurance on the life of the grantor or the grantor's spouse. Present law provides an exception if the power can be exercised only after 10 years from the transfer to the trust or the death of the income beneficiary and if the power may be used to apply corpus or income of the trust to discharge the grantor's obligation of support of a dependent, unless the power is so exercised.

Foreign trusts having United States beneficiaries

A grantor who is a United States person is treated as the owner of any foreign trust for any year that the trust has a United States person as a beneficiary.

Alimony trusts

Present law provides another exception to the grantor trust rules in the case of certain alimony trusts. Under those rules, the income of the trust will be taxable to the grantor's former spouse, and not the grantor, if the income of the trust is payable to the former spouse of the grantor pursuant to a written separation agreement or under a decree of divorce. This exception does not apply with respect to amounts paid by the trust for the support of minor children.

Reasons for Change

While the committee believes that there are many nontax reasons for the creation of trusts, the committee is concerned about the tax benefits arising under the grantor trust rules of present

law. The present rules relating to grantor trusts permit the taxation of the stream of income from assets to be separated from the ownership of those assets. This is particularly true of trusts which take advantage of the so-called "10-year rule" which results in nonapplication of the grantor trust provisions where certain powers and interests which are retained by the grantor do not become effective in the grantor for a period of 10 years. In addition, many tax practitioners have taken the position that the application of the present law grantor trust provisions can be avoided by having the prohibited powers or interests become effective in the spouse of the grantor (e.g., the spousal remainder trust).

In order to reduce the tax benefits arising from the use of trusts, the committee believes that the so-called "10-year rule" should be repealed so that a trust would be treated as a grantor trust in all cases were there is any significant possibility that interests and powers in the trust may become effective in the grantor after the creation of the trust. Moreover, the committee believes that interests and powers of spouses of the grantor should be treated as held by the grantor for purposes of the grantor trust rules.

Explanation of Provision

The bill repeals the 10-year exception of present law and replaces that rule with a rule that treats a trust as a grantor trust where there is more than a 5 percent possibility that any of the proscribed powers or interests will become effective in the grantor after the transfer of property to the trust. For this purpose, the possibility that an interest may return to the grantor or his spouse solely under intestacy laws is to be ignored under this provision.

In order to ease administration of this rule, the bill provides an exception under which the grantor is deemed not to have retained a proscribed power or interest if that interest or power can become effective in the grantor only after the death of a lineal descendant of the grantor who also is a beneficiary of that portion of the trust. In order for this rule to apply to all or a portion of a trust, the beneficiary whose life is used must have the entire present interest (as defined in sec. 2503(c)) in that trust or trust portion.

The bill also provides that, for purposes of the grantor trust provisions, the grantor is treated as holding any power or interest held by the grantor's spouse if that spouse is living with the grantor. For this purpose, a person is treated as a spouse of the grantor who is living with the grantor if that person and the grantor are eligible to file a joint return with respect to the period in which the transfer is made. The status of a person holding a power or interest as a spouse of the grantor with whom the grantor is living is to be determined at the time of the transfer of the property to the trust.

Effective Date

The provision applies to transfers in trusts made after March 1, 1986. The bill provides an exception under which the 10-year rule of present law would continue to apply to certain trusts created pursuant to binding property settlements entered into before March 1, 1986, which required the creation of a trust and the transfer to the trust of a specified sum of money by the grantor.

Revenue Effect

The provisions revising the rate schedule and grantor trust rules are estimated to increase fiscal year budget receipts by $67 million in 1987, $209 million in 1988, $226 million in 1989, $244 million in 1990, and $265 in 1991.

3. Taxable Years of Trusts (sec. 1613 of the bill and sec. 645 of the Code)

Present Law

Under present law, trusts generally are treated as conduits with respect to amounts that are distributed currently and taxed as individuals with respect amounts retained in the trust. The conduit treatment is achieved by allowing the trust a deduction for amounts that are distributed to beneficiaries during the taxable year to the extent of the distributable net income of the trust for that taxable year. Such distributions are includible in the gross income of the beneficiaries to the extent of the distributable net income of the trust. Where the trust and the beneficiaries have different taxable years, the amounts includible in the gross income of the beneficiaries are determined by reference to income of the trust for its taxable year ending with or within the taxable year of the beneficiary.

Reasons for Change

In the case where the trust has a taxable year different than the taxable year of its beneficiaries, the present law rules governing the taxation of trusts permit the deferral of taxation by one month for each month that the taxable year of the trust ends sooner than the taxable year of its beneficiaries. Thus, in the case of a taxable year of a trust ending on January 31 and the trust beneficiary on a calendar year, the taxation of trust income which is distributed to the beneficiary is deferred eleven months.

The committee believes that the ability to defer taxation on income through the selection of taxable years of trusts should be limited.[3] Accordingly, the bill would require all trusts to have a taxable year ending in October, November, or December. Where the beneficiaries of the trust use a calendar year for their taxable year (which is typically the case), this rule will permit deferral of taxation of income to be limited to three months.

Explanation of Provision

The bill requires that all trusts (both existing and newly created) adopt a taxable year ending on October 31, November 30, or December 31.

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[3] The committee recognizes that the same possibilities of deferral also are present in the case of estates. Nonetheless, the duration of estates generally is much shorter than the duration of trusts and there often is a greater need for executors of estates to select an accounting period that coincides with the administration of the estate. The bill does not, therefore, affect the present law treatment of the taxable years of estates.

Effective Date

The provision is effective for taxable years beginning after December 31, 1986. Thus, in the case of a trust with a taxable year ending on January 31, the trust must adopt a taxable year ending in October, November, or December of 1987 and the trust will have a short taxable year (i.e., a taxable year of less than 12 months) in 1987.

In order to alleviate the bunching of taxable income arising from the change in taxable years, the bill provides that the taxable income to the beneficiary attributable to any short taxable year required under the bill is to be spread over a four year period beginning with the year of change. Thus, in the above example, if the amount includible in the income of a beneficiary for the short year is $4,000, the beneficiary would include $1,000 in income in his taxable years 1987, 1988, 1989, and 1990.[4]

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $1,169 million in 1987, $123 million in 1988, $128 million in 1989, $130 million in 1990, and $132 million in 1991.

4. Requirement That Trusts and Estates Make Estimated Payments of Income Tax (sec. 1614 of the bill and secs. 6152 and 6654 of the Code)

Present Law

Under present law, trusts and estates are not required to make estimated tax payments (sec. 6654(k)). Trusts are required to pay their income tax at the time of filing of the income tax return (sec. 6151). Moreover, estates may elect to pay their income tax in four equal installments beginning with the due date of the return and for each 3 month period thereafter (sec. 6152).

Reasons for Change

The committee believes that trusts and estates should pay tax in the same manner as is required of individuals.

Explanation of Provision

The bill provides that both new and existing trusts and estates pay estimated tax in the same manner as individuals. In addition, the bill repeals the rules that permit estates to pay their tax over four equal installments.

Effective Date

The provision is effective for taxable years beginning after December 31, 1986.

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[4] This spreading of the inclusion of income applies to distributions of distributable net income of the trust. It does not apply to any accumulation distributions occuring during the short taxable year.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $427 million in 1987, $311 million in 1988, $31 million in 1989, $32 million in 1990, and $34 million in 1991.

C. Estate and Gift Tax Provisions

1. Reduction in Current Use Valuation Recapture Period for Estates of Individuals Dying Before 1982 (sec. 1616 of the bill and sec. 2032A of the Code)

Present Law

An executor may elect to value certain real property used in farming or other closely held business operations for estate tax purposes based upon its current use value rather than its full fair market value (Code sec. 2032A). If this election is made, the amount by which the estate tax is reduced under the election is subject to a special recapture tax imposed on heirs receiving the property unless the heirs continue to use the property in its qualified use for a prescribed period. In the case of individuals dying after 1976[5] and before 1982, this period is 15 years. The Economic Recovery Tax Act of 1981, reduced this recapture period to 10 years for estates of individuals dying after 1981.

Reasons for Change

The committee believes that, because of the distressed economic situation in the farming sector, requiring heirs of specially-valued property to pay a recapture tax if they do not continue to use it in farming for 15 years has an unnecessary lock-in effect. The committee determined, therefore, that the reduction in the current use valuation recapture period to 10 years enacted in 1981 should be extended to estates of individuals who died before 1982. This reduction will permit heirs of these individuals to dispose of their specially valued farm property should economic conditions warrant that action, without interfering with the Congressional objective of providing this special tax benefit only where the heirs to the farm property continue the farming operation for a substantial period (e.g. 10 years).

Explanation of Provision

The bill reduces the recapture period with respect to specially valued farm and other closely held business property included in estates of individuals dying after 1976 and before 1982, to 10 years.

Effective Date

This provision is effective on the date of enactment.

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[5] The current use valuation provision originally was enacted by the Tax Reform Act of 1976, effective for estates of individuals dying after 1976.

Revenue Effect

The provision is estimated to decrease fiscal year budget receipts by less than $5 million annually during fiscal years 1987 through 1991.

2. Time for Filing Certain Information Required for Estate Tax Current Use Valuation Elections (sec. 1615 of the Act and sec. 2032A of the Code)

Present Law

An executor may elect to value certain real property used in farming or other closely held business operations for estate tax purposes based upon its current use value rather than its full fair market value (sec. 2032A). The election may be made only on the first estate tax return filed, must comply with Treasury Department regulations, and is irrevocable once made. Additionally, all persons with an interest in the property to be specially valued must enter into an agreement to the election. The agreement must be binding under local law.

Under present law, the required agreement must be filed with the estate tax return on which the current use valuation election is made. Special rules permit additional signatures to be added to agreements after that time if the agreement, as originally filed, substantially complied with the requirements of Treasury Department regulations.

Reasons for Change

The committee is concerned that, in certain cases, the Federal estate tax return (Form 706) provided by the Treasury Department for filing estate tax returns did not sufficiently inform taxpayers of what information must be provided to elect current use valuation and that an agreement to the election is required to be attached to Form 706. The committee determined, therefore, that limited relief permitting taxpayers additional time to supply information is appropriate where taxpayers could have been misled by an absence of information on Form 706.

Explanation of Provision

The bill provides that, if an estate timely elected the current use valuation provision and provided substantially all the information elicited by Form 706, the Federal Estate Tax Return, the election is valid if the estate provides the Treasury Department with additional information necessary to perfect the election within 90 days after such additional information is requested. (This provision permits notices of election and agreements to the election to be filed late where the estate timely filed those documents to the extent requested and described on Form 706.) Failure to supply the requested information within 90 days of a request from the Treasury Department will result in an otherwise valid election being disallowed.

This relief applies to estates of individuals dying after December 31, 1976, and before January 1, 1986, provided the period of limitations for assessment of tax has not expired.

Effective Date

This provision is effective on the date of the bill's enactment.

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by less than $5 million annually.

3. Tax Treatment of Certain Disclaimers of Interests Transferred Before November 15, 1958 (sec. 1617 of the bill and sec. 2518 of the Code)

Present Law

In general, a disclaimer is a refusal to accept the ownership of property or rights with respect to property. If a qualified disclaimer is made, the Federal gift, estate, and generation-skipping transfer tax provisions apply with respect to the property interest disclaimed as if the interest had never been transferred to the person making the disclaimer. Thus, the transfer of property pursuant to the disclaimer will not be treated as a taxable gift.

Prior to the enactment of section 2518 in 1976, there were no uniform Federal disclaimer rules. Before the promulgation of Treasury Department regulations in 1958, the administrative practice of the Internal Revenue Service was to allow the Federal consequences of a disclaimer to depend upon its treatment under local law.

On November 14, 1958, the Treasury Department issued regulations (T.D. 6334) which required that a disclaimer (1) be effective under local law and (2) notwithstanding the timeliness of the disclaimer under local law, be made "within a reasonable time after knowledge of the existence of the transfer." In litigating this issue, the Treasury Department interpreted these regulations to require that a disclaimer be made within a reasonable time after the creation of the interest, rather than the time at which the interest vested, or became possessory. Thus, for example, where property was transferred to X for life, remainder to Y, both X and Y were required to disclaim within a reasonable time of the original transfer, although Y could not take possession of the property until X's death.

These regulations also applied to interests created in transfers before November 15, 1958. Thus, under the regulations, a disclaimer of an interest created in a transfer before November 15, 1958, would be qualified for Federal tax purposes only if it were made within a reasonable time after the original transfer creating the interest.

Dispute as to the timing of a qualified disclaimer generated considerable litigation, with conflicting results. The Tax Court upheld the Treasury Department position in a series of cases including *Jewett* v. *Commissioner*, 70 T.C. 430 (1978), *Estate of Halbach v.* Commissioner, 71 T.C. 141 (1978), and *Cottrell* v. *Commissioner*, 72

T.C. 489 (1979). However, the Circuit Courts were divided on the issue. The Eighth Circuit rejected Treasury's position, concluding that State law determines the validity of a disclaimer in *Keinath* v. *Commissioner,* 480 F. 2d 57 (1973) and *Cottrell* v. *Commissioner,* 628 F. 2d 1127 (1980). However, the Ninth Circuit upheld the decision in *Jewett* v. *Commissioner* in 1980 (638 F. 2d 93 (1980)) and the Supreme Court granted *certiorari.*

On February 23, 1982, the Supreme Court resolved the controversy in *Jewett* v. *Commissioner* (455 U.S. 305 (1982)) by upholding the Treasury Department position. Noting that the Treasury interpretation is entitled to respect because it has been consistently applied over the years, the Court concluded that the relevant "transfer" occurs when the interest is created and not at such later time as the interest vests or becomes possessory.

In the Tax Reform Act of 1976, Congress adopted a set of uniform rules to govern disclaimers of property interests transferred after December 31, 1976 (sec. 2518). Under these rules, a disclaimer generally is effective for Federal gift and estate tax purposes if it is an irrevocable and unqualified refusal to accept an interest in property and meets four other conditions. First, the refusal must be in writing. Second, the written refusal generally must be received by the person transferring the interest, or the transferor's legal representative, no later than nine months after the transfer creating the interest.[6] Third, the disclaiming person must not have accepted the interest or any of its benefits before making the disclaimer. Fourth, the interest must pass to a person other than the person making the disclaimer or to the decedent's surviving spouse as a result of the refusal to accept the interest.[7]

Reasons for Change

The committee determined that a limited exception to the requirements for making a qualified disclaimer is appropriate in the case of property transferred before November 15, 1958, but only if the person disclaiming the property has not accepted any of the benefits of the property and satisfied the other requirements of Treasury Department regulations in effect on the date the otherwise valid disclaimer was attempted (other than requirements dealing with the time within which such a disclaimer must be made).

Explanation of Provision

The bill treats as qualified, certain attempted disclaimers made before February 23, 1982, with respect to property interests created before November 15, 1958.

To be effective, these disclaimers must satisfy all requirements of Treasury Regulation Section 25.2511–1(c), as adopted on November 15, 1958, except for the requirement that the disclaimer be made

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[6] However, the period for making the disclaimer is not to expire until nine months after the date on which the person making the disclaimer has attained age 21.

[7] In addition, with respect to interests created after December 31, 1981, certain transfers to the person or persons who would have otherwise received the property if an effective disclaimer had been made under local law, may be treated as qualified disclaimers, provided the transfers are made timely and the transferor has not accepted the transferred interests or any of their benefits.

within a reasonable time after the transfer creating the interest. Under these rules, for example, the party making the disclaimer may not have accepted the property interest or any of its benefits before the attempted disclaimer was made, and as a result of the disclaimer, the interest may have passed without any direction on the part of the person making the disclaimer.

Effective Date

This provision is effective on the date of the bill's enactment.

Revenue Effect

This provision will have a negligible effect on Federal budget receipts; however, Government outlays in the form of tax refunds are estimated to be increased by $105 million in fiscal year 1987, $26 million in 1988, and by less than $5 million annually for subsequent years.

TITLE XVII—MISCELLANEOUS TAX PROVISIONS

A. Extension of Expiring Provisions

1. Extension and modification of the targeted jobs tax credit (sec. 1708 of the bill and sec. 51 of the Code)

Present Law

Background

The targeted jobs tax credit (Code sec. 51) was enacted in the Revenue Act of 1978 to replace the expiring credit for increased employment. As originally enacted, the targeted jobs credit was scheduled to terminate after 1981.

The availability of the credit was successively extended by the Economic Recovery Tax Act of 1981 (ERTA) for one year, the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) for two years, and the Deficit Reduction Act of 1984 (the 1984 Act) for one year. Under present law, the credit does not apply with respect to individuals who began work for the employer after December 31, 1985. For individuals who began work before 1986, the credit is available for wages paid during the following 24 months of employment.

ERTA, TEFRA, and the 1984 Act also altered the targeted group definitions and made several technical and administrative changes in the credit provisions. In addition, TEFRA authorized the appropriation of such sums as may be necessary for the expenses of administering the system for certifying targeted group membership and for the expenses of providing publicity to employers regarding the targeted jobs credit. The 1984 Act extended the authorization for appropriations for administrative and publicity expenses through fiscal year 1985.

Targeted jobs credit rules

The targeted jobs tax credit is available on an elective basis for hiring individuals from one or more of nine targeted groups. The targeted groups are (1) vocational rehabilitation referrals; (2) economically disadvantaged youths (ages 18–24); (3) economically disadvantaged Vietnam-era veterans; (4) SSI recipients; (5) general assistance recipients; (6) economically disadvantaged cooperative education students (ages 16–19); (7) economically disadvantaged former convicts; (8) AFDC recipients and WIN registrants; and (9) economically disadvantaged summer youth employees (ages 16–17).

The credit generally is equal to 50 percent of the first $6,000 of qualified first-year wages plus 25 percent of the first $6,000 of qualified second-year wages paid to a member of a targeted group. Thus, the maximum credit is $3,000 per individual in the first year of employment and $1,500 per individual in the second year of em-

ployment. With respect to economically disadvantaged summer youth employees, however, the credit is equal to 85 percent of up to $3,000 of wages, for a maximum credit of $2,550. The employer's deduction for wages must be reduced by the amount of the credit.

Reasons for Change

The committee believes that experience with the targeted jobs tax credit since its enactment in 1978 has been sufficiently promising to warrant a further three-year extension of the credit. The committee believes that such an extension will provide the Congress and the Treasury Department an opportunity to gather more information on the operation of the credit program so that its effectiveness as a hiring incentive can be more fully assessed.

Although the committee has limited the credit in certain respects, the resulting reduction in tax benefits to some employers will be wholly or partially offset in many cases by the tax savings arising from the bill's general reduction in tax rates.

Explanation of Provision

The bill extends the targeted jobs credit for three additional years. Under the bill, the credit is available for wages paid to individuals who begin work for an employer on or before December 31, 1988.

The bill also limits the credit in two respects. First, the 25-percent credit for qualified wages paid in the second year of a targeted individual's employment is repealed. Second, under the bill, no wages paid to a targeted-group member are to be taken into account for credit purposes unless the individual both (1) is employed by the employer for at least 90 days (14 days in the case of economically disadvantaged summer youth employees), and (2) has completed at least 120 hours of work performed for the employer (20 hours in the case of economically disadvantaged summer youth employees).

The bill also extends the authorization for appropriations for administrative and publicity expenses to fiscal years 1986 through 1988.

In the case of an individual who begins work for the employer after December 31, 1985 and on or before the 25th day following the date of enactment of the bill, the five-day certification requirement for targeted group eligibility will be considered met if proper certification is received or requested on or before the 30th day following the date of enactment. To the extent feasible, the Internal Revenue Service and the Department of Labor should inform employers (e.g., through press releases or announcements) of the extension of the credit and of this special certification period.

Effective Date

The provision applies with respect to individuals who begin work for the employer after December 31, 1985 and before January 1, 1989.

Revenue Effect

The provision is estimated to decrease fiscal year budget receipts by $31 million in 1986, $180 million in 1987, $327 million in 1988, $220 million in 1989, $112 million in 1990, and $65 million in 1991.

2. Expensing of costs for removal of architectural barriers to the handicapped and elderly (sec. 1707 of the bill and sec. 190 of of the Code)

Present Law

In general, present law allows electing taxpayers to deduct currently up to $35,000 of capital expenditures for the removal of architectural and transportation barriers to the handicapped and elderly (sec. 190). This rule applies to expenses paid or incurred in order to make more accessible to and usable by the handicapped and elderly any facility or public transportation vehicle owned or leased by the taxpayer for use in a trade or business.

This election is not available for expenses incurred in taxable years beginning after December 31, 1985.

Reasons for Change

The committee believes that it is desirable to continue to encourage the removal of architectural and transportation barriers to the handicapped and elderly, inasmuch as the social benefits of such expenditures may not be fully taken into account in private calculations of benefits and costs.

Explanation of Provision

The bill reinstates on a permanent basis, effective for expenses incurred in taxable years beginning after 1985, the present-law provision that allows the expensing of up to $35,000 of costs incurred in the removal of architectural and transportation barriers to the handicapped and elderly.

Effective Date

The provision is effective on the date of enactment.

Revenue Effect

The provision is estimated to decrease fiscal year budget receipts by $9 million in 1986, $17 million in 1987, $18 million in 1988, $19 million in 1989, $20 million in 1990, and $21 million in 1991.

3. Reinstatement of rules for spouses of Vietnam MIA's (sec. 1701 of the bill and secs. 2(a)(3)(B), 692(b), 6013(f)(1), and 7508(b) of the Code)

Present Law

In 1976, the Congress provided that four tax relief provisions applied to members of the U.S. Armed Forces listed as missing in action (MIA) in the Vietnam conflict.

The first provision, relating to the definition of a surviving spouse, stated that the date of death of a person in MIA status is the date of determination of death made by the Armed Forces under 37 U.S.C. secs. 555 and 556. The second provision exempted from Federal income tax the income of a member of the Armed Forces determined to have died while in MIA status, for the year in which the determination of death was made under 37 U.S.C. secs. 555 and 556 and any prior year which ends on or after the first day the member served in a combat zone. The third provision provided that the spouse of an individual in MIA status could elect to file a joint return. The fourth provision applied to the spouse of a member in MIA status the rule postponing the performing of certain acts by reason of service in a combat zone, including the filing of returns and the payment of taxes.

These relief provisions originally applied through 1978 in the case of Vietnam MIA's. However, for status determinations under 37 U.S.C. secs. 555 and 556 that were not completed, the provisions subsequently were extended through December 31, 1982.

Reasons for Change

The committee believes that these relief provisions should be retroactively reinstated with respect to Vietnam MIA's because of the continued need for such provisions.

Explanation of Provision

Under the bill, the four tax relief provisions applicable with respect to Vietnam MIA's (and their spouses) that expired after 1982 are retroactively reinstated and made permanent.

Effective Date

The provision is effective for taxable years beginning after December 31, 1982.

Revenue Effect

This provision is estimated to decrease fiscal year budget receipts by less than $5 million annually.

B. Exempt Organization Provisions

1. Exemption from unrelated business income tax for rental of mailing lists (sec. 1702 of the bill and sec. 513 of the Code)

Present Law

General rules

Under present law, certain organizations generally are exempt from Federal income tax (under Code sec. 501(a)) because of their charitable, educational, religious, or other nonprofit purposes and functions as described in section 501(c)(3). However, a tax is imposed on the unrelated trade or business income of otherwise tax-exempt organizations (secs. 511–514). The tax applies to gross income derived by an exempt organization from any unrelated trade or business regularly carried on by it, less allowable deductions directly connected with the carrying on of such trade or business, both subject to certain modifications.

An unrelated trade or business is defined as any trade or business of a tax-exempt organization the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of the charitable, educational, religious, or other nonprofit purpose and function constituting the basis for its exemption (sec. 513(a)).

Rental of mailing lists

The U.S. Court of Claims held in 1981 that income received by the Disabled American Veterans from other exempt organizations and commercial businesses for the use of its mailing lists constitutes unrelated business taxable income, and does not constitute "royalties" expressly exempted from the tax under section 512(b)(2) (*Disabled American Veterans* v. *U.S.*, 650 F.2d 1128 (1981)). The court found that, in renting its donor lists, the DAV operated in a competitive, commercial manner with respect to taxable firms in the direct mail industry; that these rental activities were regularly carried on; and that the rental activities were not substantially related to accomplishment of exempt purposes (apart from the organization's need for or use of funds derived from renting the mailing lists).

Reasons for Change

The committee believes that the unrelated trade or business tax should not be imposed on income from exchanges or rentals of donor or member lists among tax-exempt organizations eligible to receive charitable contributions.

Explanation of Provision

The bill provides that in the case of any organization exempt from tax under section 501 that is eligible to receive tax-deductible charitable contributions under section 170(c)(2) or 170(c)(3), the term unrelated trade or business does not include any trade or business of such organization that consists of exchanging names and addresses of donors to (or members of) such organization with another such tax-exempt organization, or of renting donor (or member) names and addresses to another such tax-exempt organization.

Effective Date

The provision applies to exchanges and rentals of membership lists occurring after the date of the enactment of the bill.

Revenue Effect

The provision is estimated to decrease fiscal year budget receipts by $4 million in 1986, $7 million in 1987, $8 million in 1988, $9 million in 1989, $11 million in 1990, and $12 million in 1991.

2. Tax-exempt status for certain title-holding companies (sec. 1706 of the bill and new sec. 501(c)(24) of the Code)

Present Law

Under present law, a corporation (described in sec. 501(c)(2)) that is organized for the exclusive purpose of holding title to property, collecting income therefrom, and distributing the income (less expenses) to a tax-exempt organization is itself exempt from Federal income tax. A corporation described in section 501(c)(2) is not tax-exempt if it has unrelated business taxable income other than income classified as such solely pursuant to sections 512(a)(3)(C), 512(b)(3)(B)(ii) or (13), or 514 (Treas. Reg. sec. 1.501(c)(2)–1(a)).

Present law is unclear as to whether the exemption for organizations described in section 501(c)(2) may be available for a title-holding corporation that holds property and distributes income to more than one tax-exempt organization if the tax-exempt owners are not related. The Internal Revenue Service has taken the position, in a General Counsel Memorandum (G.C.M. 37351, December 20, 1977), that in order to qualify for tax-exempt status as an organization described in section 501(c)(2), a title-holding corporation may distribute income only to one or more related tax-exempt organizations.

Reasons for Change

The committee believes that smaller, unrelated tax-exempt organizations should be able to pool investment funds for purposes of investing in real estate through a title-holding company, with the same tax treatment as is available under present law to a larger tax-exempt organization having a title-holding subsidiary that is tax-exempt as an organization described in section 501(c)(2).

Explanation of Provision

The bill adds a new category of section 501(c) tax-exempt organizations, consisting of certain corporations or trusts that are organized for the exclusive purposes of acquiring and holding title to property, collecting income from the property, and remitting the income to certain tax-exempt organizations. Tax-exempt status in this category applies only if the corporation or trust (1) has no more than 35 shareholders or beneficiaries, (2) has only one class of stock or beneficial interest, and (3) is organized for the exclusive purpose of acquiring property and holding title to, and collecting income from, such property, and remitting the entire amount of income from such property (less expenses) to one or more eligible tax-exempt organizations that are shareholders or beneficiaries of such corporation or trust.

A corporation or trust that meets all of these requirements also is entitled to use the exception to the tax on unrelated business income under the debt-financed property rules for real property (sec. 514(c)(9)), subject to the limitations contained in section 514(c)(9)(B), as applied to pass-through entities (section 514(c)(9)(D)).

In order to qualify for exemption under the new category, a title-holding company must permit its shareholders or beneficiaries (1) to dismiss, after reasonable notice, the corporation's or trust's investment adviser by majority vote of the shareholders or beneficiaries, and (2) to terminate their interest by (a) selling or exchanging their stock or beneficial interest (subject to Federal or State securities law) to any other eligible organization, as long as such sale or exchange would not increase the total number of shareholders or beneficiaries to more than 35, or (b) redeeming their stock or beneficial interest after providing 90 days notice to the corporation or trust.

The tax-exempt organizations eligible to hold interests in a title-holding company under the bill are (1) a qualified pension, profit-sharing, or stock bonus plan (sec. 401(a)); (2) a governmental pension plan (sec. 414(d)); (3) the United States, a State or political subdivision, or governmental agencies or instrumentalities; and (4) tax-exempt charitable, educational, religious, or other organizations described in section 501(c)(3).

The bill does not amend present law with respect to title-holding corporations (described in sec. 501(c)(2)) holding title to property for one or more related tax-exempt organizations.

Effective Date

The provision applies for taxable years beginning after December 31, 1986.

Revenue Effect

The provision is estimated to decrease fiscal year budget receipts by $7 million in 1987, $18 million in 1988, $33 million in 1989, $56 million in 1990, and $82 million in 1991.

3. Divestiture exemption for certain grandfathered excess business holdings of foundations (sec. 1705 of the bill and sec. 4943 of the Code)

Present Law

The Tax Reform Act of 1969 generally limited, in effect, the combined ownership of a business corporation by a private foundation and disqualified persons to not more than 20 percent of the voting stock (Code sec. 4943). For example, if the disqualified person's holdings are five percent, the foundation itself may hold only 15 percent. If persons other than disqualified persons have effective control of the corporation, the combined foundation/disqualified person holdings are limited to 35 percent.

The 1969 Act also provided special rules applicable where the business holdings of a private foundation (combined with disqualified persons) exceeded the 20-percent/35-percent limitation on May 26, 1969. These special rules also apply to holdings acquired under trusts irrevocable on that date, or certain wills executed by that date, even though the actual transfer to the foundation occurs later. In general, grandfathered holdings are permitted to be retained, but are subject to gradual reduction over several phases.

Under the first phase, the combined foundation/disqualified person holdings cannot exceed 50 percent of the voting stock of the corporation or, if less, 50 percent of the value of all outstanding shares, by May 26, 1979, if the combined ownership on May 26, 1969, was more than 50 percent; by May 26, 1984, if the combined ownership was more than 75 percent; or by May 26, 1989, if the combined ownership was more than 95 percent.

After expiration of the first phase, a second set of divestiture requirements becomes operational—

(1) If disqualified persons do not own more than two percent of the corporate voting stock at any time during the second phase (the 15 years after the close of the first phase), the combined foundation/disqualified person holdings must be reduced to not more than 35 percent by the end of that period (e.g., for a foundation which itself owned 95 percent of the stock on May 26, 1969, by May 26, 2004); and if at any time after the end of the second phase the holdings of disqualified persons exceed two percent, then the foundation itself cannot hold more than 25 percent of the voting stock.

(2) If the holdings of disqualified persons exceed two percent at any time during the second phase, then at all times thereafter the combined foundation/disqualified person holdings are limited to 50 percent, with no more than 25 percent of the voting stock being held by the foundation.

Reasons for Change

In general, the committee believes that the rationale underlying the excess business holdings rules enacted in 1969 continues to be valid today. In 1969, the Congress was concerned that managers of foundations that owned large holdings in a business tended to be relatively unconcerned about producing income to be used in charitable activities, that their attention and interest would be devoted to the operation, maintenance, and improvement of the business

while neglecting exempt activities, and that businesses owned by exempt organizations may be operated in a way that provides those businesses with a competitive advantage over businesses owned by taxable persons. In general, therefore, the Congress concluded that a private foundation should be limited in the amount of a business that it may control.

At the same time, however, the Congress provided in the 1969 Act for continued ownership of certain excess business holdings. The committee believes that it is appropriate to allow further continuation of business holding arrangements that had been established prior to May 26, 1969 if all the additional requirements set forth in the bill are satisfied for such grandfathered holdings.

Explanation of Provision

The bill provides that the section 4943 divestiture requirements will be modified for grandfathered excess business holdings (i.e., where held by the foundation on May 26, 1969, or treated as so held by reason of sec. 4943(c)(5)), if all of the following conditions are met on and after the otherwise applicable divestiture date:

(1) Disqualified persons (other than persons who are disqualified persons solely as foundation managers) and officers, directors, or employees of any business enterprise in which such foundation has such excess business holdings together do not constitute more than 25 percent of the governing board of such foundation;

(2) Directors, trustees, or officers of the foundation together do not constitute more than 25 percent of the governing board of any such business enterprise;

(3) No disqualified person (other than a person having such status solely as a foundation manager) is a director, trustee, or officer of the foundation (or has powers or responsibilities similar to those of a director, trustee, or officer) unless the disqualified person had such director, etc., status on May 6, 1986;

(4) No disqualified person receives compensation (or payment or reimbursement of expenses) from both the foundation and any such business enterprise, other than director fees (and the payment or reimbursement of expenses incident thereto) that are not excessive;

(5) The foundation does not incur liability for any taxes for failure to comply with the section 4942 payout requirements; and

(6) The foundation does not incur liability for any taxes imposed under section 4943 with respect to holdings in any business enterprise in which the foundation has holdings subject to the excess business holdings rule as modified by this provision of the bill.

The modification to the excess business holdings divestiture requirements of section 4943 made by section 1705 of the bill generally allows foundations that meet the above requirements to maintain the level of the excess business holdings held on May 26, 1969, but applies the normal divestiture rules if the foundation or disqualified persons acquire additional holdings.

Effective Date

This provision is effective as if included in section 101(l)(4) of the Tax Reform Act of 1969.

Revenue effect

This provision is estimated to decrease fiscal year budget receipts by less than $5 million annually.

C. Cooperative Housing Corporations (Secs. 1703–04 of the bill and sec. 216 of the Code)

Present Law

Overview

Under present law (sec. 216), a tenant-stockholder in a cooperative housing corporation is entitled to deduct amounts paid or accrued to the cooperative to the extent such amounts represent the tenant-stockholder's proportionate share of (1) real estate taxes allowable as a deduction to the cooperative which are paid or incurred by the cooperative, with respect to the cooperative's land or buildings, and (2) interest allowable as a deduction to the cooperative, paid or incurred by the cooperative, with respect to indebtedness contracted in the acquisition of the cooperative's land or in the acquisition, construction, rehabilitation, etc. of the cooperative's buildings.

In general, a cooperative housing corporation is a corporation (1) that has one class of stock, (2) each of the stockholders of which is entitled, solely by reason of ownership of stock, to occupy a dwelling owned or leased by the cooperative, (3) no stockholder of which is entitled to receive any distribution not out of earnings and profits of the cooperative, except on a complete or partial liquidation of the cooperative, and (4) 80 percent or more of the gross income for the taxable year of which is derived from tenant-stockholders. A tenant-stockholder generally is an individual owning fully paid-up stock in the cooperative corporation, the purchase price of which bears a reasonable relationship to the value of the cooperative's equity in its land and buildings that is attributable to the dwelling unit that the individual is entitled to occupy.

For purposes of the above rules, tenant-stockholders generally are limited to individuals. Thus, corporations, trusts, and other similar entities generally do not qualify for pass-through treatment under present law. An exception is provided where a person (including a corporation) sells property or leasehold interests to a cooperative and acquires stock in the cooperative within one year after making such transfer. In such cases, the person selling the property is treated as a tenant-stockholder for a period not exceeding three years from the date of acquisition of the stock. This treatment applies even if, by agreement with the cooperative, such person or its nominee may not occupy the house or apartment without prior approval of the cooperative.

Also under present law, a bank or other lending institution that obtains stock in a cooperative housing corporation by foreclosure is treated as a tenant-stockholder for up to three years after the date of acquisition (even if the lending institution or its nominee may not occupy the unit without prior approval of the cooperative).

For purposes of the 80-percent test, stock owned and dwellings leased by governmental entities for the purpose of providing housing facilities are not taken into account.

Allowance of depreciation deduction

In addition to deductions for rent, interest, and taxes, to the extent a tenant-stockholder uses depreciable property leased from the cooperative in a trade or business or for production of income, the tenant-stockholder is allowed a deduction with respect to the stock that gives him the right to lease the property. This deduction generally is limited to that portion of the taxpayer's adjusted basis for the stock that is allocable to the depreciable property. Present law provides that the allowance of this deduction is not to be construed to limit or deny a depreciation deduction by the cooperative itself with respect to leased property.

Reasons for Change

The committee believes that the tax treatment of corporations, trusts, and other nonindividual entities that own stock in cooperative housing corporations should be the same as that of individuals. To allow cooperatives to maintain control over occupancy of individual units, the committee believes that this treatment should apply although the cooperative retains the right to approve any individual who occupies a house or apartment as a nominee of an entity owning stock in the cooperative.

In connection with the above change, the bill disallows maintenance and lease deductions by tenant-stockholders in situations where the property used by such stockholders is properly chargeable to the capital account of the cooperative. This change eliminates the ability of a tenant-stockholder to obtain deductions for the capital costs of his cooperative unit more quickly than if he had owned the unit.

Explanation of Provision

Definition of tenant-stockholder

The bill amends the definition of tenant-stockholder to mean any person (rather than any individual) who satisfies the requirements otherwise applicable to tenant-stockholders. Thus, under the bill, corporations, trusts, estates, partnerships, associations, or companies (as well as individuals) may be tenant-stockholders qualifying for pass-through treatment.

If a person other than an individual acquires stock in a housing cooperative, there shall not be taken into account, for purposes of determining whether the person is a qualifying tenant-stockholder, the fact that, by agreement with the cooperative, such person's nominee may not occupy the house or apartment without prior approval of the cooperative. This change enables, for example, a corporation owning stock in the cooperative to qualify for pass-through treatment although the cooperative retains the right to approve any individuals who occupy units under arrangements with the corporation.

The bill further provides that, in the case of an original seller of houses or apartments to a housing cooperative (including individuals or other entities), there shall not be taken into account the fact that, by agreement with the cooperative, the original seller or its nominee may not occupy a house or apartment without prior approval of the cooperative. This rule applies where the original seller acquires stock not later than one year after transferring houses or apartments (or leaseholds therein) to the cooperative.

Also under the bill, where any person acquires stock of a cooperative housing corporation by operation of law (including acquisition by inheritance or foreclosure), for purposes of determining whether such person is a qualifying tenant-stockholder, there shall not be taken into account the fact that, by agreement with the cooperative, such person or his nominee may not occupy the house or apartment without prior approval of the cooperative.

The present-law rules regarding original sellers and foreclosures by lending institutions are made unnecessary by these changes and therefore are repealed.

Limitation on depreciation deduction

Under the bill, a tenant-stockholder using depreciable property in a trade or business or for the production of income is allowed a deduction as under present law to the extent of that portion of his adjusted basis for his stock that is allocable to such depreciable property. The bill further allows deductions exceeding this basis to be carried over to succeeding taxable years. However, the bill provides that no deduction may be allowed to a stockholder for any amount paid or accrued to the cooperative (in excess of proportionate interest and real estate taxes) to the extent that, under regulations issued by the Secretary of the Treasury, such amount is properly allocable to amounts chargeable to the cooperative's capital account. Any deduction disallowed under this rule will be applied to increase the stockholder's adjusted basis for his stock. This rule generally prevents a tenant-stockholder (including a corporation) from obtaining deductions for the capital costs of his cooperative unit more quickly than if he had owned the unit.

Effective Date

The provisions of the committee bill relating to the ownership requirements of cooperative housing corporation shares is effective for taxable years beginning after December 31, 1986. Special rules are provided for two specified limited-profit housing cooperatives relating to the treatment of specified loan refinancings, the treatment of income earned on the reserve fund of such cooperatives in taxable years beginning prior to January 1, 1986, and the treatment of payments made from the respective reserve funds in taxable years beginning after December 31, 1985.

Revenue Effect

The provision is estimated to decrease fiscal year budget receipts by $5 million annually.

TITLE XVIII—TECHNICAL CORRECTIONS PROVISIONS

The technical corrections title contains clerical, conforming, and clarifying amendments to provisions enacted by the Tax Reform Act of 1984, which was part of the Deficit Reduction Act of 1984 (P.L. 98-369), the Retirement Equity Act of 1984 (P.L. 98-397), and other recently enacted tax legislation. All amendments made by the title are meant to carry out the intent of Congress in enacting the original legislation. Therefore, no separate "Reasons for Change" is set forth for each individual amendment.

These provisions are treated as enacted immediately before the other provisions of this Act.

TECHNICAL CORRECTIONS TO THE TAX REFORM ACT OF 1984

A. Technical Corrections to Tax Freeze and Tax Reform Provisions

1. Tax Freeze Items

a. Finance lease rules (sec. 1801(a) of the bill and sec. 12(c) of the Act)

Present Law

Under the finance lease rules, the fact that a lessee has a fixed-price purchase option or the leased property is limited use property is not taken into account in determining whether the agreement is a lease. The Tax Reform Act of 1984[1] ("The Act") postponed the effective date of the finance lease rule, except for property acquired pursuant to a binding contract entered into before March 7, 1984, and certain other property.

Explanation of Provision

Under the bill, taxpayers can elect to have the amendment that defers the finance lease rules apply to any agreement entered into before March 7, 1984.

In addition, certain specified farm finance leases are not to be disqualified where a C corporation becomes a partner or beneficiary in the partnership or trust which was the lessor.

[1] Division A of the Deficit Reduction Act of 1984 (P.L. 98-369).

b. Telephone excise tax (sec. 1801(b) of the bill and sec. 4251 of the Code)

Present Law

The Act extended the three-percent telephone excise tax through December 31, 1987. Due to a clerical error in enrolling the Act, the year 1985 was inadvertently deleted.

Explanation of Provision

The bill restores the year 1985 to the table of years for which the three-percent telephone excise tax applies.

c. Electronic funds transfer for alcohol and tobacco excise taxes (sec. 1801(c) of the bill and secs. 5061 and 5703 of the Code)

Present Law

The act requires persons who were liable for $5 million or more in any alcohol or tobacco excise tax during the preceding calendar year to pay that tax by electronic funds transfer during the succeeding calendar year.

Explanation of Provision

The bill clarifies that all corporations that are members of a controlled group of corporations are treated as one person for purposes of the electronic funds transfer requirement. The term controlled group of corporations has the same meaning as under Code section 1563, except a 50-percent, rather than an 80-percent, common ownership test is applied. It is understood that the Treasury Department administratively will apply this 50-percent common ownership requirement only with respect to taxes due after March 28, 1985.

Additionally, Treasury Department authority to apply these principles to a group of persons under common control where some members of the group are not corporations is clarified.

d. Distilled spirits held in foreign trade zones (sec. 1801(c)(3) of the bill and sec. 27(b) of the Act)

Present Law

The Act increased the excise tax rate on distilled spirits from $10.50 to $12.50 per proof gallon, effective October 1, 1985. Previously removed spirits held for sale on that date were subject to a $2 "floor stocks" tax (subject to certain exceptions).

Because of the interaction of these provisions with the provisions regarding foreign trade zones (*see*, 19 U.S.C. sec. 81a *et seq.*), it was not clear whether distilled spirits held in a foreign trade zone on October 1, 1985, and subsequently entered into U.S. customs territory, would be subject to the floor stocks tax.

Explanation of Provision

The bill clarifies that distilled spirits held in a foreign trade zone on October 1, 1985, and entered into U.S. customs territory after that date, are subject to the floor stocks tax.

2. Tax-Exempt Entity Leasing

a. Treatment of use in unrelated trade or business (sec. 1802(a)(1) of the bill and sec. 168(j)(3)(D) of the Code)

Present Law

In the case of 19-year real property, the Act defines "tax-exempt use property" as the portion of property that is leased to tax-exempt entities under disqualified leases. This definition applies only if the portion of the property leased in a disqualified lease is more than 35 percent of the property. The Act also provides that the term "tax-exempt use property" does not include any portion of a property that is used predominantly in a tax-exempt entity's unrelated trade or business.

Explanation of Provision

The bill clarifies that the portion of a property that is used in a tax-exempt entity's unrelated trade or business is not treated as used pursuant to a disqualified lease. For example, assume that a tax-exempt entity leases 100 percent of a building for a term of 21 years. Eighty percent of the building is used in the tax-exempt entity's unrelated trade or business, and 20 percent is used in its exempt function. No portion of the building constitutes tax-exempt use property because the portion used in a disqualified lease (20 percent) is less than 35 percent of the property.

b. Treatment of certain previously tax-exempt organizations (sec. 1802(a)(2) of the bill and secs. 168(j)(4)(E) and (9) of the Code)

Present Law

Under the Act, the term "tax-exempt entity" includes any organization (other than certain farmers' cooperatives) that was exempt from U.S. income tax at any time during the five-year period ending on the date the property involved is leased to such organization (or any successor organization engaged in substantially similar activities).

Explanation of Provision

The bill clarifies that the rule for former tax-exempt organizations is not limited to property that is leased to such organizations; the rule applies with respect to any property other than property owned by a former tax-exempt entity or a successor organization. Under the bill, the five-year period ends on the date the property involved is "first used" by a former tax-exempt entity. Property is treated as first used by an organization (a) when the property is first placed in service under a lease to such organization, or (b) in

the case of property owned by a partnership (or other pass-through entity) of which the organization is a member, the later of the day on which the property is first used by the partnership (or other pass-through entity) or the day on which the organization is first a member of such partnership (or other pass-through entity).

For purposes of the rules relating to property owned by a partnership, any "tax-exempt controlled entity" is treated as a tax-exempt entity. The term "tax-exempt controlled entity" is defined as any corporation that is not a tax-exempt entity if 50 percent or more (by value) of the corporation's stock is held directly or (by application of section 318) indirectly by one or more tax-exempt entities. In applying section 318, the rules relating to attribution from a corporation are to be applied without regard to the 50-percent test. Therefore, an entity will be treated as owning its proportionate share of stock held by a corporation in which the entity has a direct ownership interest, regardless of the entity's ownership percentage. For example, assume that each of three unrelated tax-exempt entities utilizes a wholly owned taxable subsidiary to invest in one-third of the stock of a fourth taxable corporation. The fourth taxable corporation acquires an interest in a partnership holding depreciable property. Under section 318(a)(2)(C), each tax-exempt entity would be treated as owning one-third of the stock in the fourth taxable corporation. Therefore, the fourth taxable corporation would constitute a tax-exempt controlled entity. Because the rules for attribution from a corporation are applied without the 50-percent threshold, the same result would obtain if the three unrelated tax-exempt entities invested in one-third of the stock of a single taxable corporation, and the taxable corporation organized a second taxable corporation; here, the second taxable corporation would constitute a tax-exempt controlled entity.

A tax-exempt controlled entity is not treated as a tax-exempt entity (or as a successor to a tax-exempt entity) if an election is made to treat any gain recognized by a tax-exempt entity on disposition of an interest in the tax-exempt controlled entity (as well as any dividends or interest received or accrued from the tax-exempt controlled entity) as unrelated business taxable income under section 511. The election binds all tax-exempt entities holding interests in the tax-exempt controlled entity.

The amendment relating to tax-exempt controlled entities applies to property placed in service after March 1, 1986, except property acquired pursuant to a written contract that was binding on that date and at all times thereafter. A tax-exempt controlled entity can elect to have the amendments apply to property placed in service on or before March 1, 1986.

The bill also clarifies that the Federal Home Loan Mortgage Corporation is not treated as a tax-exempt entity.

c. Repeal of overlapping regulatory authority (sec. 1802(a)(3) of the bill and sec. 168(j)(5)(C)(iv) of the Code)

Present Law

The Act authorized the Treasury to determine whether any high-technology telephone station equipment or medical equipment is subject to rapid obsolescence. The Act also provides that the Treas-

ury is to prescribe any other regulations that may be necessary or appropriate to carry out the purposes of section 168(j) (sec. 168(j)(10)).

Explanation of Provision

The bill repeals the overlapping regulatory authority relating to high-technology equipment.

d. Partnership rules (sec. 1802(a)(4) of the bill and secs. 168(j)(8)–(9) and 48(a)(5) of the Code)

Present Law

The Act provides that sections 168(j)(8) (relating to property leased to a partnership) and 168(j)(9) (relating to property owned by a partnership) apply for purposes of paragraphs (4) and (5) of section 48(a) (relating to the nontaxable use restriction on investment credits).

Explanation of Provision

The bill clarifies the manner in which the partnership rules in section 168(j) apply for purposes of the investment credit provisions. Any portion of a property that is treated as tax-exempt use property by application of paragraph (8) or (9) of section 168(j) is excluded from the definition of section 38 property under paragraphs (4) and (5) of section 48.

e. Treatment of certain aircraft leased to foreign persons (sec. 1802(a)(5) of the bill and secs. 47(a) and 48(a) of the Code)

Present Law

Section 47(a)(7) provides an exception to the investment credit recapture rules for certain leases of aircraft for use predominantly outside the United States. This exception applies if, inter alia, an aircraft that qualified for the credit in the taxable year in which it was placed in service would otherwise cease to qualify as section 38 property because it is used predominantly outside the United States.

Under the Act, generally, property that is leased for a term of less than six months qualifies as section 38 property, even if the lease is to a foreign person or entity. In the case of aircraft that is leased to a foreign person before January 1, 1990, and is used under a lease that qualifies for treatment under section 47(a)(7), investment credits are not recaptured if the term of such lease does not exceed three years.

Explanation of Provision

The bill clarifies that the short-term lease exception for aircraft is intended to permit the operation of section 47(a)(7), where property would otherwise cease to qualify as section 38 property because it is leased to a foreign person for use predominantly outside the United States, and not to provide an exception to the definition of section 38 property. The application of this provision is illustrat-

ed by the following example. Assume an aircraft is placed in service by a U.S. air carrier on January 1, 1986, and is used for the entire taxable year solely in the United States. On January 1, 1987, the aircraft is leased to a foreign person for use predominantly outside the United States, under a "qualifying lease" (within the meaning of section 47(a)(7)). The term of the lease is two years. Because of the application of new section 47(a)(9), as well as section 47(a)(7), no investment credit is recaptured. If such aircraft is disposed of or otherwise ceases to be section 38 property, investment credit recapture will be determined by disregarding the term of the lease to the foreign person. In the example above, at the end of the two-year lease term, although the U.S. air carrier has actually owned the aircraft for three years, the taxpayer is considered to have used the plane for only one year for purposes of the recapture rules.

f. Section 593 organizations (sec. 1802(a)(6) and (8) of the bill and sec. 46(e)(4) of the Code)

Present Law

Under the Act, the lessor of property to a section 593 organization (or "thrift institution") is entitled to no greater a credit with respect to such property than the thrift institution would have been entitled to had it owned the property. The Act also provides rules designed to prevent taxpayers from circumventing the rules with respect to leased property by use of certain arrangements, other than service contracts but including partnerships, under which a thrift institution obtains the use of property.

Explanation of Provision

The bill clarifies present law by expressly providing that a thrift institution cannot avoid the restriction on property leased to a section 593 organization by use of a partnership.

The bill also clarifies that the tax credit for rehabilitation expenditures is allowable on buildings leased to section 593 organizations in accordance with the rules applicable to buildings leased to tax-exempt entities.

g. Treatment of certain property held by partnerships (sec. 1802(a)(7) of the bill and sec. 168(j)(9) of the Code)

Present Law

If a tax-exempt entity's share of partnership items would be treated as income or loss from an unrelated trade or business under section 511, then the partnership's property will not be treated as tax-exempt use property.

Explanation of Provision

The bill clarifies that the determination of whether a tax-exempt partner's share of partnership items is treated as derived from an unrelated trade or business is to be made without regard to the debt-financed income rules of section 514.

h. Treatment of service contracts (sec. 1802(a)(9)(C) of the bill and sec. 7701(e) of the Code)

Present Law

Section 7701(e) provides rules for use in determining whether an arrangement structured as a service contract is more properly treated as a lease.

Explanation of Provision

Section 7701(e)(4) is amended by adding a cross reference to the definition of "related entity" in section 168(j).

i. Effective date provisions (sec. 1802(a)(10) of the bill)

(1) Section 31(g)(3)(B) of the Act is amended to clarify that transitional relief is provided only from the application of section 168(j)(9) (as added by the Act).

(2) Section 31(g)(4) of the Act is amended to clarify that certain credit unions qualify for transitional relief, that governmental action before May 23, 1984 qualifies a successor plan for the Greenville, South Carolina, Coliseum, and that certain actions taken with respect to the Essex County, New Jersey, Courthouse qualify as significant governmental action.

(3) Effective for property placed in service by the taxpayer after July 18, 1984, section 31(g)(15)(D) of the Act is amended to clarify that the transitional rule for certain aircraft applies to aircraft originally placed in service after May 23, 1983.

(4) Section 31(g)(17)(H) is amended to clarify that, in the case of Clemson University, the term "property" includes only the Continuing Education Center and component housing projects.

(5) Section (g)(17)(L) is amended to clarify that it applies to the Pennsylvania Railroad Station in Newark, New Jersey.

(6) Section 31(g)(20)(B)(ii) of the Act, which provides that improvements to property that qualify for transitional relief also qualify for relief unless the improvement is a substantial improvement, is amended to clarify that the substantial-improvement exception to the rule applies to personal property, as well as real property. This amendment will not apply to personal property if there was a binding written contract to acquire, construct, or rehabilitate the property (or if construction, reconstruction, or rehabilitation of the property began) on or before March 28, 1985.

3. Bonds and Other Debt Instruments

a. Treatment of amounts received on disposition of short-term obligations (sec. 1803(a)(1), (2) and (3) of the bill and sec. 1271 of the Code)

Present Law

Section 1271 expressly provides that any gain realized on disposition of governmental short-term obligations is treated as ordinary income, to the extent of the ratable share of accrued acquisition discount. Long-standing judicial authority and Treasury regulations provide a basis for characterizing accrued original issue dis-

count (OID) as ordinary income on disposition of nongovernmental obligations.

Explanation of Provision

The bill clarifies the treatment of amounts received on disposition of nongovernmental obligations. Under a general rule, any gain realized on disposition of a short-term nongovernmental obligation is treated as ordinary income to the extent of the ratable share of accrued OID. Taxpayers may elect to accrue OID with respect to a short-term nongovernmental obligation under an economic accrual formula, pursuant to which the daily portion of the discount is computed on the basis of the taxpayer's yield to maturity based on the issue price of the obligation, compounded daily. A similar election is provided for the computation of acquisition discount with respect to short-term governmental obligations. An election to account for discount under an economic accrual formula cannot be revoked without the consent of the Secretary.

b. Treatment of deduction of OID on short-term obligations (sec. 1803(a)(4) of the bill and sec. 163(e) of the Code)

Present Law

In general, interest on a debt instrument with a maturity of one year or less which is payable at the maturity of the instrument is not deductible by a cash-method issuer until paid. See Treas. Reg. sec. 1.1232–3(b)(1)(iii) (providing that such interest is not included in the "stated redemption price at maturity" for purposes of section 1232, the predecessor of section 1273).

Explanation of Provision

The bill clarifies present law by expressly providing in section 163(e) that a cash basis issuer of a short-term debt instrument may deduct original issue discount and any other interest only in the year of payment. A similar provision was included in the Conference Report to the Act. That provision was deleted in House Concurrent Resolution 328 (June 29, 1984) because it was deemed to be a mere restatement of preexisting law.

It is understood that some taxpayers have interpreted the deletion of this provision from the Concurrent Resolution as evidencing an intent to modify the prior-law proscription against deduction of interest on an accrual basis by cash-method issuers of short-term obligations. The purpose of this amendment is to clarify that no such result was intended.

c. Treatment of certain transfers of market discount bonds (sec. 1803(a)(5) of the bill and sec. 1276(d) of the Code)

Present Law

Under the act, an obligation issued in an exchange subject to section 351 (which provides nonrecognition treatment where appreciated property is transferred to an 80-percent owned corporation in exchange for stock or securities of the corporation) may fall within the definition of the term "market discount bond," without regard

to whether the property transferred is a market discount bond (see the discussion of present law, below). Thus, taxpayers are prevented from circumventing the rule that characterizes accrued market discount as interest by swapping a market discount bond for a new bond in a section 351 exchange. A different result may obtain, however, where a taxpayer swaps a market discount bond for stock in a section 351 exchange.

Explanation of Provision

The bill clarifies that taxpayers are prevented from circumventing the market discount provisions by transferring a bond with accrued market discount in a section 351 exchange. Under the bill, accrued market discount is taxed to the transferor of a market discount bond in a section 351 exchange, regardless of whether the transferor receives stock or securities in the exchange. The corporate transferee of the market discount bond will take the bond with a basis that reflects any gain recognized to the transferor (sec. 362(a)). If the stated redemption price of the bond exceeds the transferee's basis immediately after acquisition, then the bond will constitute a market discount bond in the hands of the transferee.

d. Treatment of bonds acquired at original issue for purposes of market discount rules (sec. 1803(a)(6) of the bill and sec. 1278(a) of the Code)

Present Law

Because market discount is defined as any excess of stated redemption price over basis (excluding OID), it is arguable that market discount is created on issuance of obligations in certain nonrecognition (or nontaxable) exchanges. An example is provided by the application of the statutory definition to a bond issued in a section 351 exchange. Under section 358, the basis of a bond received in a section 351 exchange is determined by reference to the basis of the property transferred in exchange for the bond (in the hands of the transferor). Thus, the stated redemption price of the bond will exceed its basis to the extent of any appreciation in the transferred property. Assuming no OID, this excess could be viewed as market discount.

The Act provides that the rule that characterizes accrued market discount as interest on disposition of a bond is inapplicable to bonds issued on or before July 18, 1984. If a pre-enactment bond is exchanged for a newly issued bond in a tax-free transaction, however, the new bond is subject to the interest characterization rule, even if the holder of the bond essentially maintains the original investment.

Explanation of Provision

The bill clarifies that, except as provided by statute or by regulation, no market discount is created on the original issuance of a bond.

Under the bill, two statutory exceptions are provided. The first exception relates to bonds that are part of an issue that is publicly offered. Because the Act provides that the issue price of publicly

offered bonds (other than bonds issued for property) is the price at which a substantial amount of the bonds are sold, the OID provisions are inapplicable to a portion of the OID with respect to bonds acquired on original issue by large investors at "wholesale" prices (at deeper discounts than those available to "retail" customers). Under the bill, market discount is created on original issuance of a bond if the holder has a cost basis determined under section 1012, and such basis is less than the issue price of the bond. The difference between the holder's issue price and basis is treated as market discount.

The second statutory exception applies to a bond that is issued in exchange for a market discount bond pursuant to a plan of reorganization. This exception is intended to prevent the holder of a market discount bond from eliminating the taint of unaccrued market discount by swapping the bond for a new bond (e.g., in a recapitalization). Solely for purposes of the interest characterization rule, however, this exception is inapplicable to a bond issued in exchange for a pre-enactment market discount bond where term and interest rate of the new bond is identical to that of the old bond.

If the adjusted basis of a bond is determined by reference to the adjusted basis of the bond in the hands of a person who acquired the bond at original issue, the bond will be treated as acquired by the taxpayer at its original issue.

e. Treatment of certain stripped bonds or stripped coupons (sec. 1803(a)(7) of the bill and sec. 1281(b) of the Code)

Present Law

The Act requires the current inclusion in income of OID or acquisition discount with respect to short-term obligations held by certain taxpayers. This provision was intended to limit the scope of the rules that permit deferral to the ordinary investor.

Explanation of Provision

The bill requires the current inclusion in income of OID with respect to stripped bonds and stripped coupons held by the taxpayer who stripped the bond or coupon (or any other person whose basis is determined by reference to the basis in the hands of the stripper).

f. Accrual of interest on certain short-term obligations (sec. 1803(a)(8) of the bill and sec. 1281(a) of the Code)

Present Law

Under section 1281 of the Code, certain taxpayers are required to include in income as interest for a taxable year that portion of the acquisition discount or OID on a short-term obligation that is allocable to the portion of the taxable year during which the taxpayer held the obligation. Acquisition discount is defined as the excess of the stated redemption price at maturity over the taxpayer's basis in the obligation. Similarly, OID is defined as the excess of the stated redemption price at maturity over the issue price of the obli-

gation. The taxpayers affected are those for whom the cash method of accounting for interest income from short-term obligations is considered inappropriate.

Explanation of Provision

The bill clarifies that taxpayers subject to the rule for mandatory accrual are required to include in income for a taxable year all amounts of interest allocable to that year with respect to short-term obligations, irrespective of whether the interest is stated or is in the form of acquisition discount or OID, and irrespective of when any stated interest is paid. For example, a calendar-year taxpayer designated in section 1281(b) holds an obligation from the time it is issued on October 1, 1985 until its maturity on October 1, 1986. Under the bill, the taxpayer is required to include in income for 1985 the equivalent of three months interest on the obligation, regardless of whether the interest income is in the form of acquisition discount, OID, stated interest, or any combination thereof.

The provision will apply to obligations acquired after March 1, 1986.

g. Treatment of debt instruments issued for property where there is public trading (sec. 1803(a)(10) of the bill and sec. 1273(b) of the Code)

Present Law

Under section 1273(b) of the Code, if a debt instrument is issued for property and either the debt instrument is traded on an established securities market or the property for which it is issued is stock or securities which are traded on an established securities market, the issue price of the instrument is the fair market value of the property.

Explanation of Provision

The bill permits the Secretary to designate in regulations other types of publicly traded property which for purposes of the issue price provisions will be treated like publicly traded stock or securities.

h. Amortization of bond premium (sec. 1803(a) (11) and (12) of the bill and sec. 171 of the Code)

Present Law

If a taxable bond is purchased at a premium (i.e., at a price that exceeds the redemption price), the holder may elect to amortize the bond premium over the term of the bond (sec. 171). Amortizable bond premium is allowed as an ordinary deduction. In computing amortizable bond premium, taxpayers are permitted to use a straight-line method. For purposes of these rules, the term "bond" is defined to exclude bonds issued by individuals. An election to amortize bond premium is effective for all bonds held or acquired at or after the beginning of the first taxable year for which the election is made.

Explanation of Provision

The bill conforms the treatment of bond premium to the treatment of bond discount: bond premium is to be computed under a constant yield method. Amortizable bond premium is computed on the basis of the taxpayer's yield to maturity, determined by using the taxpayer's basis for the bond, and compounding at the close of each "accrual period" (as defined in section 1271(a)(5)). The bill also extends section 171 to obligations issued by individuals.

The provisions will apply to obligations issued after March 1, 1986. For taxpayers who have elections in effect as of the date of enactment, such elections will apply to obligations issued after that date only if the taxpayer so chooses (in such manner as may be prescribed by the Secretary).

The bill also provides that, in determining bond premium for bonds issued after May 6, 1986, the basis of the bond shall be treated as not exceeding its fair market value where the bond was received in an exchange in which the basis of the bond is determined by reference to the basis of the other property. This rule generally will not apply to an exchange of securities in a reorganization.

i. Clarification of transitional rule (sec. 1803(b)(1) of the bill and sec. 44 of the Act)

Present Law

Section 44(b) of the Act (relating to effective dates), as amended by section 2 of Public Law 98-612, provides special test and imputation rates under sections 1274 and 483 for certain transactions occurring before July 1, 1985.

Explanation of Provision

The bill clarifies that the effective date for new section 1274 and section 483 as amended by the Act—transactions after December 31, 1984—is not accelerated by section 2 of Public Law 98-612.

j. Clarification of interest accrual with respect to transactions involving adequate stated interest (sec. 1803(b) (2) and (3) of the bill and sec. 44(b)(3) of the Act)

Present Law

Section 44(b)(3)(A)(i)(I) of the Act provides that, after March 1, 1984, and before January 1, 1985 (the date on which new section 483 becomes effective), the unstated interest allocable to a taxable year must be computed on an economic accrual basis. Section 44(b)(3)(A)(i)(II) proscribes the accrual of interest on a noneconomic basis with respect to debt instruments issued in a sale or exchange after June 8, 1984, and before January 1, 1985, where there is adequate stated interest for purposes of section 483. The Act contains an exception for transactions pursuant to binding contracts in effect on March 1, 1984.

Explanation of Provision

The bill clarifies that, in the case of debt instruments issued for property in transactions occurring after December 31, 1984, whether involving adequate stated interest or inadequate stated interest, interest may not be computed using any method other than economic accrual, as described in Rev. Rul. 83–84, 1983–1 C.B. 9.

The bill also changes the binding contract date applicable to transactions involving adequate stated interest. The exception to the statutory requirement of economic accrual is made applicable to transactions occurring pursuant to a written contract that was binding on June 8, 1984 and at all times thereafter until the transaction was closed. No inference is intended regarding the proper treatment (under other provisions of the Code, or under general tax law principles) of noneconomic accruals of interest with respect to obligations issued before the effective date of the Act.

4. Corporate Provisions

a. Debt-financed portfolio stock (sec. 1804(a) of the bill and sec. 246A of the Code)

Present Law

The Act added a provision generally limiting the dividends received deduction for dividends received by a corporate shareholder with respect to debt-financed portfolio stock.

Explanation of Provision

The bill clarifies the rules for applying the provision in cases in which dividends are received from certain foreign corporations engaged in business in the United States. For example, assume that 70 percent of a domestic corporation's purchase price for portfolio stock of a foreign corporation described in section 245(a) is debt financed. Assume further that 60 percent of that foreign corporation's gross income is effectively connected with the conduct of a trade or business in the United States. In the absence of section 246A, the domestic corporation generally would be entitled to deduct 51 percent (85 percent times 60 percent) of any dividend received from the foreign corporation. Under section 246A and the bill, the domestic corporation generally is entitled to deduct only 15.3 percent ((30 percent times 85 percent) times 60 percent) of any such dividend.

b. Holding period rules for dividend received deduction (sec. 1804(b)(1) of the bill and sec. 246(c) of the Code)

Present Law

Under present law, as amended by the Act, a corporation must hold stock for more than 45 days (90 days in the case of certain preference dividends) in order to obtain a dividend received deduction with respect to any dividend on that stock. Days more than 45 days after the ex-dividend date and days on which the corporation's risk of loss is diminished are not taken into account. Under these rules, it can thus be determined on the 45th day after the ex-divi-

dend date whether or not the holding period requirement will be met. However, present law disallows the deduction only if the stock has been disposed of by the corporation. Thus, present law may retroactively deny the dividends received deduction when the corporation disposes of the stock. This may require filing amended returns in some cases and in other cases the period of limitations may expire.

Explanation of Provision

The bill disallows the dividend received deduction where the holding period requirement is not met, without regard to whether the stock has been disposed of. Thus, where the holding period requirement has not been met on the 45th day (90th day in the case of certain preference dividends) after the ex-dividend date, the dividend received deduction will not be allowed. The amendment is not intended to require, for example, that the holding period be met by the date the dividend is received where the stock was acquired less than 45 days before that date, provided the stock is held for 45 days or more. No inference is intended as to the proper interpretation of present law.

The provision will apply to obligations acquired after March 1, 1986.

In addition, the committee wishes to clarify that the 1984 Act did not change the principle that the dividend received deduction is not disallowed by reason of an out-of-the money call option that affords the corporation no protection against loss in the event the stock declines in value. See Revenue Ruling 80–238, 1980–2 C.B. 96.

c. Application of related party rule to section 265(2) of the Code (sec. 1804(b)(2) of the bill and sec. 53(e) of the Act)

Present Law

Section 265(2) of the Code disallows the deduction of interest incurred or continued to purchase or carry tax-exempt obligations. This rule applies both to individual and corporate taxpayers.

The Act (Code sec. 7701(f)) provides that the Treasury Department is to prescribe such regulations as may be necessary or appropriate to prevent the avoidance of Federal tax provisions which deal with (i) the linking of borrowing to investment, or (ii) diminishing risks, through the use of related persons, pass-through entities, or other intermediaries. This provision was specifically intended to apply to (but not to be limited to) the disallowance rule provided by section 265(2).

Under the Act, the provision regarding related persons, pass-through entities, and other intermediaries was effective on the date of enactment (July 18, 1984).

Explanation of Provision

Under the bill, the provision regarding related parties, pass-through entities, and other intermediaries generally remains effective as of July 18, 1984 (i.e., the date of enactment). However, the bill clarifies that this provision, insofar as it relates to section 265(2) of the Code only, is effective for (1) term loans made after

July 18, 1984, and (2) demand loans outstanding after July 18, 1984 (other than any loan outstanding on July 18, 1984, and repaid before September 18, 1984). "Demand loans" mean any loan which is payable in full at any time on the demand of the lender. For purposes of this effective date rule, any loan renegotiated, extended, or revised after July 18, 1984, is treated as a loan made after such date.

d. Exempt-interest dividends from regulated investment companies (sec. 1804(c) of the bill and sec. 852 of the Code)

Present Law

Prior to the Act, a taxpayer could convert short-term capital gain into long-term capital gain by buying stock of a regulated investment company (or real estate investment trust) immediately before the ex-dividend date of a long-term capital gain distribution, receiving that distribution, waiting 32 days, and then selling the stock. The Act made conversion of this type more difficult. However, a problem similar to the long-term capital gain distribution problem that existed before the Act remains with respect to exempt-interest dividends received from a regulated investment company. Under present law, a taxpayer can buy stock of a regulated investment company immediately before the ex-dividend date of an exempt-interest dividend, receive that dividend, wait 32 days, and then sell the stock. Any loss on the sale generally is recognized.

Explanation of Provision

Under the bill, if a taxpayer holds stock of a regulated investment company for 6 months or less, any loss on the sale or exchange of that stock is disallowed to the extent the taxpayer received exempt-interest dividends with respect to that stock. Conforming amendments are made, and an exception is provided for dispositions pursuant to a periodic liquidation plan.

In addition, the Secretary is given authority to shorten the 6 months requirement to a period of not less than the greater of 31 days or the period between regular dividend distributions where the RIC regularly distributes at least 90 percent of its net tax-exempt interest. The distribution period is to be shortened only where the purpose of the holding period requirement can be adequately fulfilled without requiring that the stock be held 6 months. It is intended that a RIC which regularly distributes between 90 percent and 110 percent of its net tax-exempt income earned between dividend payment dates has satisfied the purposes of the holding period requirement.

The provision applies to stock with respect to which the taxpayer's holding period begins after March 28, 1985.

e. Accumulated earnings tax (sec. 1804(d) of the bill and sec. 562 of the Code)

Present Law

Prior to the Act, individual taxpayers attempted to convert dividend income into capital gains through the use of non-RIC invest-

ment companies which received dividend income (which was eligible for a dividends received deduction) and did not distribute that income to their individual shareholders. In order to prevent this result, the Act clarified that these corporations were subject to the accumulated earnings tax. However, it may still be possible to avoid dividend treatment through the use of stock redemptions, whereby the shareholder receives capital gains treatment and the investment company is relieved of the accumulated earnings tax (sec. 562(b)(1)).

Explanation of Provision

The bill provides that, except to the extent provided by the Secretary of the Treasury, no dividends paid deduction will be allowed, for purposes of the accumulated earnings tax, in the case of any stock redemption by a mere holding or investment company which is not a regulated investment company. The bill will apply to redemptions after March 1, 1986.

f. Definition of affiliated group (sec. 1804(e) (1) and (9) of the bill and sec. 1504 of the Code)

Present Law

The Act substantially revised the definition of "affiliated group". To apply the new rules, a determination must be made as to the ownership of "stock" of a corporation. Under the Act and section 1504(a)(4), "stock" does not include stock which, among other things, has redemption and liquidation rights which do not exceed the paid-in capital or par value represented by such stock (except for a reasonable redemption premium in excess of such paid-in capital or par values).

Members of an affiliated group of corporations may file (or be required to file) consolidated returns. To be a member of an affiliated group for this purpose, a corporation has to be an "includible corporation". Under section 1504, certain corporations do not qualify as includible corporations. Thus, for example, a former DISC is not an includible corporation. Nor is a subsidiary of a former DISC. Under prior law, the accumulated DISC income of a former DISC was included in the gross income of its shareholders, as a dividend, over a period of up to 10 years. If the former DISC and its parent could file a consolidated return, the former DISC's accumulated DISC would go untaxed, i.e., the parent would eliminate the "dividend" under Treas. regs. sec. 1.1502-14.

The Act substantially revised the rules relating to DISCs and former DISCs. Under the new rules, there is less reason to keep a former DISC and its parent from filing consolidated returns. Furthermore, if a former DISC is not treated as an includible corporation, its parent may be able to selectively deconsolidate subsidiaries.

Explanation of Provision

Section 1504(a)(4) is amended to exclude stock which has redemption and liquidation rights which do not exceed the issue price of such stock (except for a reasonable redemption or liquidation pre-

mium). The amendment makes irrelevant the accounting treatment given the issuance of the stock.

Under the bill, any DISC or any other corporation that has accumulated DISC income derived after 1984 will not be an includible corporation. It is intended that this provision will not affect the status of certain S corporations with DISC subsidiaries who were "grandfathered" by the Subchapter S Revision Act of 1982.

g. Effective date of affiliated group provision (sec. 1804(e) (2), (3), (4), and (5) of the bill and sec. 60 of the Act)

Present Law

The Act substantially revised the definition of "affiliated group". The provision was generally effective for taxable years beginning after December 31, 1984. However, section 60(b)(2) of the Act provided a grandfather rule with respect to any corporation which on June 22, 1984, was a member of an affiliated group filing a consolidated return for such corporation's taxable year which includes June 22, 1984—for purposes of determining whether such corporation continues to be a member of such group for taxable years beginning before January 1, 1988, the provision does not apply. Under section 60(b)(3) of the Act, the grandfather rule described in the preceding sentence does not apply once a "sell-down" with respect to the corporation involved has occurred.

Explanation of Provision

The bill makes several technical changes with respect to the effective date rules.

First, the grandfather rule ceases to apply as of the first day after June 22, 1984, on which the corporation involved would not qualify as a member of the group under prior law. Thus, for example, a corporation which ceased to be a member of a group on July 31, 1985, under prior law but which on July 31, 1985 (and thereafter), qualifies as a member of the group under the Act's substantive rule is treated as continuing to be a member of the group.

Second, the bill amends section 60(b)(3) of the Act to clarify the "sell-down" exception to the grandfather rule. Thus, the exception does not apply, and the grandfather rule continues to apply, if the percentage interest (by fair market value) in the stock of the corporation involved held by other members of the group (determined without regard to section 60(b)(3) of the Act) does not decline as a result of the sale, exchange, or redemption of such corporation's stock. Also, the bill provides that the "sell down" exception applies in certain cases where there is a letter of intent between a corporation and securities underwriter entered into on or before June 22, 1984.

Third, the bill allows a common parent corporation to elect to have this provision apply to taxable years beginning after December 31, 1983.

Finally, the bill delays the effective date for one specified corporation until the earlier of January 1, 1994, or the date on which the voting power of certain preferred stock terminates.

h. Complete liquidations of subsidiaries, etc. (sec. 1804(b)(3), (e)(6), (7) and (8) of the bill and secs. 332, 337 and 338 of the Code)

Present Law

Prior to the Act, the rules applicable in determining whether a corporation qualified as a corporation which could be liquidated under section 332 were substantially similar to the general rules applicable in determining whether that corporation was a member of an affiliated group under section 1504. The Act substantially amended the general rules of section 1504 but not those of section 332. As a result, there is now discontinuity between the two sections. Thus, a corporation might be liquidated tax free under section 332 even though it and its "parent" are not members of the same affiliated group under new section 1504. The converse is also true. This discontinuity may produce unacceptable tax consequences.

For example, assume that beginning on January 1, 1985, P Corporation's ownership of S Corporation satisfies new section 1504 but not present-law section 332 and that, under new section 1504, P and S file consolidated returns for the 1985 calendar year. Assume further that (1) S adopts a plan of complete liquidation in 1985, then sells all its assets, and then liquidates within 12 months from the date the plan is adopted, and (2) P does not liquidate. Because S's liquidation does not qualify under section 332, S may be able to avail itself of section 337 (sec. 337(c)(2)). That result is appropriate so long as P is taxed on S's liquidation, as would in general be the result given the inapplicability of section 332. However, since P and S file a consolidated return, S's liquidation would not be taxable to P under Treas. regs. sec. 1.1502-14(b) (assuming S distributes no cash to P in the liquidation). Therefore, S could dispose of all its assets and liquidate, with neither P nor S incurring any current tax liability.

As a further example, assume that (1) J Corporation's ownership of K Corporation stock satisfies present-law section 332 but not new section 1504, and (2) the two corporations are not filing a consolidated return under section 60(b)(2) of the Act for their 1985 calendar year. Assume further that K adopts a plan of complete liquidation, on January 1, 1985, then sells all its assets, and then liquidates within 12 months. Under section 332, the liquidation would not be taxable to J. Furthermore, it would appear that, since J and K are not in a new section 1504(a)(2) relationship, K may be able to avail itself of section 337 (sec. 337(c)(3)). Again, K could dispose of its assets and liquidate, with neither J nor K incurring any tax liability. (On the other hand, if J and K were filing consolidated returns under section 60(b)(2) of the Act, K could not avail itself of section 337 unless J timely liquidated. J would be a "distributee corporation" under section 337(c)(3)(B) since new section 1504 would not yet apply.)

Explanation of Provision

The bill amends section 332. Section 332 will not apply unless, among other things, the corporation receiving the liquidating dis-

tribution was, on the date of the adoption of the plan of liquidation and continued to be at all times until receipt of the liquidating distributions, the owner of stock in the liquidating corporation meeting the requirements of new section 1504(a)(2). In applying section 1504(a)(2) for this purpose, the objective is to harmonize section 332 and section 1504(a)(2). Thus, it is generally intended that other parts of new section 1504(a), e.g., section 1504(a)(4), are applicable. However, section (a)(5)(E) is not applicable. It is not concerned with section 1504(a)(2) but rather with the effect of transfers within a group of a member's stock.) The new rule also applies even if one (or both) of the corporations involved is not an includible corporation under section 1504(b). Under this rule, S in the first example above could be liquidated under section 332. However, S could avail itself of section 337 only if P complied with section 337(c)(3)(A)(i). In the second example above, J would be taxed because section 332 would not apply and because J and K, by definition, could not be filing a consolidated return.

Under the bill, the term "distributee corporation" under section 337(c)(3) is also amended. The amendment defines the term to mean any corporation which receives a distribution in a complete liquidation of the selling corporation to which section 332 applies. It also includes each other corporation "up the line" which receives a distribution in complete liquidation of another distributee corporation to which section 332 applies. Thus, assume, for example, that (1) M owns 100 percent of the stock of N, (2) N owns 100 percent of the stock of O, and (3) the 3 corporations are filing a consolidated return under new section 1504 for the calendar year 1985. If M transfers 30 percent of the stock of N to O, under regulations, the 3 corporations would continue to be eligible (or be required) to file a consolidated return (sec. 1504(a)(5)(E)). If N adopted a plan of complete liquidation, sold all its assets, and then liquidated within 12 months, under Treas. regs. sec. 1.1502-34, both M and O generally would be entitled to tax-free treatment under section 332. Under the bill, N could not avail itself of section 337 unless, among other things, both M and O complied with section 337(c)(3)(A)(i).

Also, under the bill, the definition of "qualified stock purchase" in section 338 is conformed to the definition in section 1504(a)(2). The change will apply where the 12 month acquisition period begins after March 1, 1986.

The amendment to section 337(c)(3)(B) applies with respect to plans of complete liquidation pursuant to which any distribution is made in a taxable year beginning after December 31, 1984. Thus, in the example above involving J and K, K could not avail itself of section 337 unless J timely liquidated because J would be a "distributee corporation" under the amendment.

Except as indicated below, the amendment to section 332 is generally applicable with respect to distributions pursuant to plans of liquidation adopted after March 28, 1985. Except as indicated below, the amendment is also applicable with respect to distributions pursuant to a plan of complete liquidation adopted on or before that date, but only if (1) any distribution is made in a taxable year beginning after December 31, 1984, and (2) the liquidating corporation and any corporation which receives a distribution in complete liquidation of such corporation are members of an af-

filiated group of corporations which is filing a consolidated return for the taxable year which includes the distribution. However, the amendment to section 332 does not apply with respect to distributions pursuant to any plan of complete liquidation if the liquidating corporation is a member of an affiliated group of corporations under section 60(b)(2) or (5) (relating to Native Corporations established under the Alaska Native Claims Settlement Act) of the Act for each taxable year in which it makes a distribution.

The application of the effective date rules is illustrated by the following examples.

Example (1).—Assume that Q Corporation's ownership of the stock of R Corporation satisfies section 332 of present law and section 1504 of prior law but not section 332 as it is amended by the bill. (Under these facts, Q and R could not be filing a consolidated return unless grandfathered under the Act's amendment of section 1504). Assume further that R adopts a plan of complete liquidation on October 1, 1984, then sells its assets, and, then, before October 1, 1985, completely liquidates. Regardless of whether Q and R are filing consolidated returns under section 60(b)(2) of the Act for the calendar year 1985, and regardless of whether the liquidation is completed before January 1, 1985, the amendment to section 332 would not apply. As a result, R's liquidation could qualify under section 332. (However, R could avail itself of section 337 only if Q timely liquidated.)

Example (2).—Assume that S Corporation's ownership of the stock of T Corporation would satisfy new section 332 but not section 332 of present law or section 1504 of prior law. Assume further that on October 1, 1984, T adopts a plan of complete liquidation and then, making no sales or exchanges of assets in the interim, completes its liquidation on October 5, 1984. The amendment to section 332 would not apply. As a result, section 332 could not apply.

Example (3).—The facts are the same as in Example (2) except that (a) T adopts its plan on January 10, 1985, and completes its liquidation on January 15, 1985, and (b) S and T file a consolidated return for the calendar year 1985 under new section 1504. The amendment to section 332 would be applicable. As a result, section 332 could be applicable.

Example (4).—The facts are the same as in Example (2) except that T sells assets between October 1, 1984, and October 5, 1984. New section 332 would not be applicable. As a result, section 332 could not apply, and T could avail itself of section 337.

Example (5).—The facts are the same as in Example (3) except that T sells assets between January 10, 1985, and January 15, 1985. The amendment to section 332 would apply. As a result, section 332 could apply. If it did, T could not avail itself of section 337 unless, among other things, S timely liquidated. (If S and T were not filing a consolidated return under new section 1504 for the calendar year 1985, the amendment to section 332 would not apply. As a result, T's liquidation would not be a section 332 liquidation, and T could avail itself of section 337.)

Example (6).—Assume that Corporation U's ownership of the stock of Corporation V satisfies section 332 of present law but not section 332 as it would be amended and that U and V are filing a

consolidated return for the calendar year 1985, under section 60(b)(2) of the Act. On December 10, 1985, V adopts a plan of complete liquidation, then sells all its assets, and then liquidates on December 15, 1985. The amendment to section 332 would not apply. As a result, section 332 could apply. If it did, V could avail itself of section 337 only if, among other things, U timely liquidated.

Finally the bill delays the effective date of the amendment made to section 311(d) in the case of one specified parent-subsidiary group.

i. Earnings and profits (sec. 1804(f) of the bill and sec. 312 of the Code)

Present Law

The Act substantially revised the definition of corporation's "earnings and profits".

One change was to increase a distributing corporation's earnings and profits by the amount of any gain which would be recognized if section 311(d)(2) did not apply to an ordinary, non-liquidating distribution by the corporation of appreciated property. However, the Act added no separate provision for reducing earnings and profits for all or any portion of that amount.

The Act also amended the rules regarding the effect on earnings and profits of a corporation's redemption of its own stock (sec. 312(n)(8) of current law). However, the Act did not contain a specific effective date for that amendment.

Explanation of Provision

The bill repeals section 312(n)(4) and section 312(c)(3) and amends section 312(b). Under 312(b), as amended, the distribution by a corporation of property the fair market value of which exceeds its adjusted basis increases the earnings and profits of the distributing corporation by the amount of such excess. The distribution results in a decrease to earnings and profits under the general rules of section 312(a). Thus, assume that a corporation has no accumulated earnings and profits and no other current earnings and profits. Assume further that in 1985 it distributes property with a zero basis and a $1,000 value to an individual shareholder in a transaction described in section 311(d)(2). The distribution increases the distributing corporation's earnings and profits of the taxable year to $1,000. Thus, the distributing corporation's earnings and profits for the taxable year (as determined at the close of the taxable year under Treas. Reg. § 1.316-1(a)(1)) shall account for all gain attributable to the distribution of appreciated property.

The bill provides that section 312(n)(8) of current law applies to redemption distributins in taxable years beginning after September 30, 1984.

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j. Treatment of transferor corporation (sec. 1804(g) and (h)(3) of the bill and secs. 361 and 368 of the Code)

Present Law

In general, gain or loss is not recognized by a transferor corporation on the transfer of property pursuant to a plan of reorganization. However, gain is recognized where money or other property received is not distributed by the tansferor pursuant to the plan of reorganization. The Act generally required that all property be distributed in a "C" reorganization. Nevertheless, if the transferor corporation uses money or other property to satisfy its liabilities, the transferor corporation may be treated as realizing gain on the transfer to the acquiring corporation.[2]

In addition, under present law it is not entirely clear whether or not the nonrecognition provisions applicable to corporate liquidations apply to a corporate reorganization.[3]

Explanation of Provision

The bill amends section 361 to provide that the transferor corporation does not recognize gain or loss on the transfer to the acquiring corporation pursuant to the plan of reorganization, without regard to whether properties received are distributed pursuant to the plan of reorganization.

In addition, the bill clarifies that sections 336 and 337 (relating to liquidations) are not applicable to transfers of property pursuant to the plan of reorganization, but that section 311(d), requiring recognition of gain, is applicable to distributions of property pursuant to a plan of reorganization by any corporation which is a party to the reorganization. The bill provides that any property received by a transferor corporation in a reorganization will have a fair market value. In addition, in the case of a C reorganization, no gain or loss will be recognized on any disposition pursuant to the reorganization of stock or securities which were received pursuant to the plan of reorganization and which are in another corporation which is a party to the reorganization.

The bill also clarifies that the distribution requirement of section 368(a)(2)(G) will be satisfied where distributions are made to creditors, as well as shareholders, of the transferor corporation.

These provisions will apply to plans of reorganizations adopted after date of enactment of this Act.

The bill also clarifies that a reorganization, involving a "drop-down" of assets to a subsidiary, which qualifies as a "C" reorganization, without regard to section 368(a)(2)(A) (relating to reorganizations described in both paragraphs (C) and (D) of section 368(a)(1)), will continue to qualify as a reorganization.

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[2] See Minnesota Tea Company v. Helvering, 302 U.S. 609 (1938), Rev. Rul. 70-271, 1970-1 C.B. 166.

[3] See FEC Liquidating Corporation v. United States, 548 F.2d 924 (Ct. Cl. 1977) (the application of which would deny nonrecognition treatment under section 337 on a "deemed sale" of stock to a creditor); and, General Housewares Corporation v. United States, 615 F.2d 1056 (5th Cir. 1980) (holding that section 337 applied where the acquired corporation sold part of the stock received as considertion for its assets in a reorganization and used the sale proceeds to pay debts).

k. Collapsible corporations (sec. 1804(i) of the bill and sec. 341 of the Code)

Present Law

Under present law, subject to certain exceptions, gain from the sale or exchange of a "collapsible" corporation which has been held for more than 6 months is treated as ordinary income.

Explanation of Provision

The bill applies the collapsible corporation provisions whether or not the stock has been held 6 months. The provision will apply to sales and exchanges after March 1, 1986.

l. Golden parachutes (sec. 1804(j) of the bill and sec. 280G of the Code)

Present Law

Under present law (sec. 280G), no deduction is allowed for "excess parachute payments" and a nondeductible 20-percent excise tax is imposed on the recipient of any excess parachute payment.

Parachute payment

A "parachute payment" is any payment (1) in the nature of compensation (including payments to be made under a covenant not to compete or similar arrangement); (2) to (or for the benefit of) a "disqualified individual"; and (3) which is contingent on a change in the ownership or effective control of a corporation, or on a change in the ownership of a substantial portion of the assets of a corporation, but only if the aggregate present value of all such payments made or to be made to the disqualified individual equals or exceeds 3 times the disqualified individual's "base amount."

The disqualified individual's "base amount" is the average annual income in the nature of compensation with respect to the acquired corporation includible in the disqualified individual's gross income over the 5 taxable years of such individual preceding the individual's taxable year in which the change in ownership or control occurs.

A "disqualified individual" means any individual who is an employee, independent contractor, or other person specified in regulations who performs personal services for the corporation and who is an officer, shareholder, or highly compensated individual of such corporation. Sec. 280G does not define the term "highly compensated individual." Personal service corporations and similar entities generally are treated as individuals for this purpose.

To be a parachute payment, a payment must be contingent on a change in ownership or control. In general, a payment is to be treated as contingent on a change in ownership or control if such payment would not, in fact, have been made had no change in ownership or control occurred. A payment generally is to be treated as one which would not, in fact, have been made unless it is substantially certain, at the time of the change, that the payment would have been made whether or not the change occurred.

A payment may also be contingent on a change in ownership or control if the change determines the time such payment is in fact to be made. Present law does not require that a payment that is merely accelerated b a change in ownership or control to be treated as contingent on the change if the acceleration does not increase the present value of the payment. For example, the exercise of a currently vested and exercisable stock appreciation right (SAR) or a stock option, the original receipt or vesting of which was not treated as a payment in the nature of compensation, is not treated as a parachute payment merely because a change in control determines the time at which the SAR or stock option is exercised because the change in control does not affect, in any way, the present value of the SAR or stock option.

In addition, a payment generally is not treated as a parachute payment to the extent the disqualified individual transfers cash or property in consideration for the payment. For example, if the original receipt or vesting of a stock option is treated as a payment in the nature of compensation, the exercise of the option is not treated as a parachute payment because the holder of the option transfers, in consideration for the stock, cash (the exercise price) and property (the option) having a total fair market value equal to the stock. The committee expects that, except as otherwise provided in regulations, the vesting of an option with an ascertainable fair market value (whether or not readily ascertainable as defined in Reg. section 1.83-7(b)) will be treated as the payment in the nature of compensation.

Similarly, if an employee receives the payment of his or her vested account balance in an individual account plan, whether or not qualified under the Code (sec. 401(a)), and actual interest or other earnings on plan assets are credited to each account as earned and prior to distribution, early payment normally would not increase the present value of this amount and this payment would not be a parachute payment. On the other hand, if a vested employee receives a pension benefit on change in control and the amount of the benefit is not actuarially reduced to reflect payment before the employee otherwise would have received payment absent the change of control, the employer is subsidizing the value of the early payment and the pension benefit would be a parachute payment. The amount of the benefit that is a parachute payment is the excess of the present value of the subsidized early payment over the present value of the benefit if it were payable at the date that the employee otherwise would retire under the plan."

"Excess parachute payments" are any parachute payments in excess of the base amount that are not reasonable compensation for personal services actually rendered (or to be rendered) by the disqualified individual. Under present law, the taxpayer has the burden of establishing, by clear and convincing evidence, that a parachute payment is reasonable compensation for personal services actually rendered (or to be rendered).

To the extent a taxpayer establishes that the payment involved is reasonable compensation for personal services, the payment involved is first applied against the base amount.

Reasonable compensation

Payments of compensation previously earned are generally to be treated as reasonable compensation under present law, assuming they qualify as reasonable compensation under section 162. For example, if pension benefits are earned at a rate of 2 percent a year times years of service times final average compensation, benefits earned for service before a change in control are amounts previously earned. Therefore, these benefits are treated as reasonable compensation under this provision (after discounting for the probability that, absent the change, they would otherwise have been forfeited) if they so qualify under section 162 even if the benefits vest on a change in control. Of course, because these payments would not have otherwise been made without the change in control, they would be parachute payments. Solely for purposes of the parachute provisions, severance payments would not be treated as reasonable compensation because such payments are not made as payments for services rendered or to be rendered.

Violation of securities laws or regulations

Under present law, the term parachute payment also includes any payment under a contract that (1) provides for payments of a type which the Congress intended to discourage by enacting the new rules, and (2) violates any applicable Federal or State securities laws or regulations. However, the rules relating to reasonable compensation do not apply for purposes of determining how much of any such parachute payment is excessive and, therefore, the entire amount of such parachute payment in excess of the base amount is an excess parachute payment.

The treatment of a securities law violation as a parachute payment does not apply if the violation is merely technical in character or is not materially prejudicial to shareholders or potential shareholders.

Application

In determining whether payments contingent on a change in ownership or control equal or exceed 3 times the base amount, the value of amounts to be paid in the future is determined on a present value basis in accordance with the principles of section 1274(b)(2). Under that section, a discount rate equal to 120 percent of the applicable Federal rate, compounded semiannually, is used.

The provisions apply to that part of each parachute payment which is in excess of the portion of the base amount allocated to such payment. Under present law, the portion of the base amount allocated to any payment is that portion of the base amount determined by multiplying the base amount by a fraction, the numerator of which is the present value of such payment, and the denominator of which is the aggregate present value of all such payments.

Effective dates

The provisions of the Act are effective for payments made under contracts entered into or renewed after June 14, 1984. The provisions are also effective for all payments made under a contract entered into before June 15, 1984, if, after June 14, 1984, the contract

is amended or supplemented in significant relevant respect. A contract generally is to be treated as amended or supplemented if it is amended or supplemented to add or modify, to the executive's benefit, a change in ownership or control trigger, to increase amounts payable (or, if payment is to be made under a formula, to modify, to the executive's advantage, the formula) in the event of such a trigger, or to accelerate the payment of amounts otherwise payable at a later date in the event of such a trigger.

Explanation of Provisions

Exemption for certain corporations

In general.—Under the bill, the term parachute payment does not include any payment made to (or for the benefit of) a disqualified individual (1) with respect to a corporation that was, immediately before the change in control, a small business corporation or (2) with respect to a corporation no stock of which was, immediately before the change in control, readily tradable on an established securities market, or otherwise, provided shareholder approval was obtained with respect to the payment to a disqualified individual.

Small business corporation.—A corporation qualifies as a small business corporation if the corporation does not (1) have more than 35 shareholders, (2) have a shareholder who is not an individual (other than an estate or a qualifying trust), (3) have a nonresident alien as a shareholder, and (4) have more than one class of stock.

Corporation with no readily tradable securities.—The Secretary of the Treasury may, by regulations, provide that a corporation fails to meet the requirement that it have no stock that is readily tradable if a substantial portion of the assets of any entity consists (either directly or indirectly) of stock in the corporation and interests in the entity are readily tradable on an established securities market, or otherwise. For example, if a publicly traded corporation sells the stock of a 70 percent subsidiary and the assets of the subsidiary constitute a substantial portion of the assets of the parent, the committee intends that the exemption for a corporation with no readily tradable securities will not be available with respect to payments to disqualified individuals on account of the change in ownership or control of the subsidiary.

The committee is also concerned that, absent specific rules, a taxpayer might utilize the exemption for shareholder approval to avoid the golden parachute provisions by creating tiers of entities. Such avoidance is possible if the gross value of the entity-shareholder's interest in the corporation constitutes a substantial portion of such entity's assets. The committee contemplates that, in such cases, the Secretary will adopt regulations requiring approval of the owners of the entity rather than the approval of the entity itself. Of course, such shareholder approval may be obtained only if the entity shareholder also has no stock that is readily tradable. On the other hand, if the entity's interest in the corporation constitutes less than substantial portion of its assets, approval of the compensation arrangement by the authorized officer of the entity is sufficient because, under present law, the golden parachute provisions do not apply to the sale of less than a substantial portion of the assets of a corporation (in this case, the entity).

The shareholder approval requirements are met with respect to any payment if (1) the payment is approved by a separate vote of the shareholders who, immediately before the change in ownership or control, hold more than 75 percent of the voting power of all outstanding stock of the corporation and (2) adequate disclosure was made to all shareholders of the material facts concerning payments that, absent this exemption, would be parachute payments.

The committee intends that adequate disclosure to shareholders will include full and truthful disclosure of the material facts and such additional information as may be necessary to make the disclosure not materially misleading. Further, the committee intends that an omitted fact will be considered material if there is a substantial likelihood that a reasonable shareholder would consider it important.

A disqualified individual who is to receive payments that would be parachute payments (absent shareholder approval) and who is a shareholder is removed from the shareholder base against which the shareholder approval test is applied. A shareholder who is related (under the principles of sec. 318) to the disqualified individual described in the preceding sentence is also removed from the shareholder base. If all shareholders are disqualified individuals or related to disqualified individuals, then disqualified individuals are not removed from the shareholder base.

Reasonable compensation

In the case of any payment made on account of a change in ownership or control, the amount treated as a parachute payment will not include the portion of such payment that the taxpayer establishes by clear and convincing evidence is reasonable compensation for personal services to be rendered on or after the date of the change in ownership or control. Moreover, such payments are not taken into account in determining whether the threshold (i.e., 3 times the base amount) contained in the definition of parachute payments is exceeded.

The committee intends that reasonable compensation for services to be rendered may include, under certain circumstances, payments to an individual as damages for a breach of contract. For example, if an employer fires an employee before the end of a contract term, the amount the employee collects as damages for salary and other compensation may be treated as reasonable compensation for services to be rendered if (1) the damages do not exceed the compensation the individual would have received if the individual continued to perform services for the employer; (2) the individual demonstrates, by clear and convincing evidence, that the payments were received because an offer to work was made and rejected; and (3) any damages were reduced by mitigation. One the other hand, if damages are collected for a failure to make severance payments, damages collected would not be for personal services to be rendered because the individual does not have to demonstrate a willingness to work and reduce damages by mitigation.

The committee intends that evidence that amounts paid to a disqualified individual for services to be rendered that are not significantly greater than amounts of compensation (other than compensation contingent on a change in ownership or control or termina-

tion of employment) paid to the disqualified individual in prior years or customarily paid to similarly situated employees by the employer or by comparable employers will normally serve as clear and convincing evidence of reasonable compensation for such services.

The amount treated as an excess parachute payment is reduced by the portion of the payment that the taxpayer establishes by clear and convincing evidence is reasonable compensation for personal services actually rendered before the change in control. For purposes of this provision, reasonable compensation for services performed before the date of change is first offset against the base amount.

Exemption for payments under qualified plans

Under the bill, the term parachute payment does not include any payment from or under a qualified pension, profit-sharing, or stock bonus plan (sec. 401(a)), a qualified annuity plan (sec. 403(a)), or a simplified employee pension (sec. 408(k)). Moreover, such payments from or under a qualified plan are not taken into account in determining whether the threshold for excess parachute payments is exceeded.

Treatment of affiliated groups

The bill provides that, except as otherwise provided in regulations, all members of an affiliated group of corporations (sec. 1504) shall be treated as a single corporation for purposes of the golden parachute provisions. Any person who is an officer or highly compensated individual with respect to any member of the affiliated group is treated as an officer or highly compensated individual of such single corporation. Notwithstanding the general definition of an affiliated group of corporations, for purposes of this provision, an affiliated group of corporations also includes the following:

(1) Tax-exempt corporations;

(2) Insurance companies;

(3) Foreign corporations (unless the disqualified individual is employed by a foreign corporation that is acquired by another foreign corporation, neither of which is subject to tax in the U.S.);

(4) Corporations with respect to which a possession tax credit election (sec. 936) is in effect for the taxable year);

(5) Regulated investment companies and real estate investment trusts; and

(6) A DISC or former DISC.

Definition of highly compensated individual

Under the bill, the term highly compensated individual is defined to include only an employee (or a former employee) who is among the highest-paid one percent of individuals performing services for the corporation or for any corporation that is a member of an affiliated group or the 250 highest paid individuals who perform services for a corporation or for each member of an affiliated group.

Excluded amounts

Under the bill, amounts that are not treated as parachute payments are not taken into account in determining whether the threshold contained in the definition of parachute payments is exceeded. This provision applies to (1) payments made with respect to a small business corporation or a corporation that satisfies the shareholder approval requirements; (2) payments that are reasonable compensation for personal services to be rendered on or after the date of the change of control; and (3) payments from or under a qualified plan.

Securities laws violation

The bill limits the treatment of payments made pursuant to an agreement that violates securities laws as parachute payments only to violations of generally enforced securities laws or regulations. Further, the Internal Revenue Service is to bear the burden of proof with respect to the occurrence of a securities law violation.

Effective date

The provisions are effective as if enacted in DEFRA. For example, amounts paid before the date of enactment under an agreement otherwise subject to the golden parachute provisions may be exempt from such provisions under the small business corporation exception, the shareholder approval exception, the exception for payments from or under a qualified plan, or exceptions for payments of reasonable compensation for services to be rendered. In addition, shareholder approval could be obtained after the date of enactment with respect to prior transactions.

Further, the committee intends that a contract is not treated as amended in a significant, relevant respect under certain circumstances. For example, if a nonqualified stock bonus plan is amended to prevent the forfeiture of previously granted but unvested shares in the event of the termination of the plan following a merger, consolidation, or sale, such an amendment is not treated as amending the plan in a significant, relevant respect. This rule applies provided that participants in the plan are entitled to no grandfathered parachute benefits that have the effect of compensating them for the possible forfeiture of shares in the event of a merger, consolidation, or sale of the corporation. Under the plan, if the company terminates the plan, the vesting of previously granted shares would continue as if the plan had not been terminated. If the company is sold, however, the plan could be terminated without allowing previously granted shares to continue to vest. Under this situation, participants are not entitled to benefits that are contingent on a change in ownership or control. Instead, the plan amendment merely prevents the possible forfeiture of benefits that could occur only in the event of the merger, consolidation, or sale of the corporation. On the other hand, whether an award made after June 14, 1984, under the plan constitutes a parachute payment will depend on the facts and circumstances at the time the award is made.

m. Corporate tax preferences (sec. 1804(k) of the bill and sec. 291 of the Code)

Present Law

The Act generally increased the corporate tax preference cutback (sec. 291) from 15 to 20 percent.

Explanation of Provision

The bill makes several clerical amendments, including a clarification that the prior law DISC provision did not apply to subchapter S corporations.

5. Partnership Provisions

a. Retroactive allocations (sec. 1805(a) of the bill and sec. 706(d) of the Code)

Present Law

The Act provides that specified cash basis items are allocated to the persons who were partners during the period to which the items were economically attributable. Items (or portions of items) which are attributable to periods before the beginning of the taxable year are assigned to the first day of the taxable year. The items are allocated to the persons who were partners during the period to which each item is attributable, in accordance with their varying interests in the partnership during that period. If the persons to whom all or part of such item is allocable are not partners in the partnership on the first day of the partnership taxable year in which the item is properly taken into account, their portion of such item must be capitalized by the partnership and allocated to the basis of partnership assets.

Explanation of Provision

The bill clarifies that the rule described in present law applies to all cases in which the rule is necessary to allocate cash basis items to the period to which the items are attributable, even though no change in partnership interests occurs during the current taxable year.

b. Disguised sale transactions (sec. 1805(b) of the bill and sec. 707(a)(2)(B) of the Code)

Present Law

The Act provides that, under Treasury regulations, if (1) a partner transfers money or other property (directly or indirectly) to a partnership, (2) there is a related direct or indirect transfer of money or other property by the partnership to that partner (or another partner), and (3) when viewed together, the transfers described above are properly characterized as a sale of property, the transaction is to be treated (as appropriate) as a transaction between the partnership and a non-partner or as a transaction between two or more partners acting in non-partnership capacities. This "disguised sale" rule is intended to prevent the parties from

characterizing a sale or exchange of property as a contribution to the partnership followed by a distribution from the partnership, and thereby to defer or avoid tax on the transaction.

Explanation of Provision

The bill specifies that "disguised sale" treatment is to apply to cases in which the transfers to and from the partnership (as described above), when viewed together, are properly characterized as an exchange of property, as well as to cases in which such transfers are properly characterized as a sale.

c. Transfers of partnership interests by corporation (sec. 1805(c)(1) of the bill and sec. 386 of the Code)

Present Law

The Act provided that for purposes of determining the amount (and character) of gain recognized by a corporation on any distribution or liquidating sale or exchange of a partnership interest, the distribution (or sale or exchange) is treated as a distribution (or sale or exchange) of the corporation's proportionate share of the recognition property of the partnership.

Explanation of Provision

The bill amends section 386 to specifically limit the amount of gain recognized by a corporation upon a distribution of a partnership interest in a nonliquidating distribution to which section 311 applies. The maximum amount of gain recognized by a corporation upon distribution to which section 311 applies of any partnership interest is the gain that would have been recognized upon the sale of the distributed interest at its fair market value. Thus, for example, a corporation that acquired its interest by making a cash contribution to an existing partnership would recognize no gain if it immediately distributed the interest to its shareholders, regardless of the basis of the partnership property attributable to its interest.

The amendment to section 386 does not affect the recognition of recapture income by a distributing corporation. Under section 751(a), a partner is required to treat the sale of a partnership interest as a sale or exchange of property other than a capital asset to the extent of the unrealized receivables (including recapture property) and inventory of the partnership attributable to the transferred interest. Thus, a corporation making a distribution of a partnership interest will recognize depreciation recapture with respect to the partnership recapture property attributable to the distributed interest.

The Secretary is given authority to promulgate regulations to prevent the use of this provision to avoid the nonrecognition of loss rule of section 311(a). In particular, the Committee is concerned that prior to a distribution of partnership interests a corporation might contribute to a partnership property the adjusted basis of which exceeds its fair market value, thereby reducing the gain inherent in the distributed partnership interests. Such "netting" of gain and loss property is not permitted by section 311 if loss property is distributed by a corporation. The Secretary should limit the

application of this provision where a distribution is preceded by the contribution of loss property to the partnership if the principal purpose of the contribution is to avoid the nonrecognition of loss rule.

d. Distributions treated as exchanges for purpose of partnership provisions (sec. 1805(c)(2) of the bill and sec. 761(e) of the Code)

Present Law

The Act provides that any distribution not otherwise treated as an exchange is to be treated as an exchange for purposes of specified partnership provisions of the Code. The provisions to which this rule applies are section 708 of the Code (relating to continuation of a partnership); section 743 (relating to the optional adjustment to the basis of partnership property); and any other partnership provision (subchapter K of the Code) specified in Treasury regulations.

Explanation of Provision

The bill limits the application of the sale or exchange treatment rule to partnership interests which are distributed. The bill also allows the Secretary to provide exceptions to these rules. It is intended that exceptions might include a distribution of a partnership interest by an estate or testamentary trust by reason of the death of a partner will not be treated as a sale or exchange for purposes of section 708(b).

e. Like-kind exchanges (sec. 1805(d) of the bill and sec. 1031(a) of the Code)

Present Law

Under the Code (section 1031), generally no gain or loss is recognized if property held for productive use in the taxpayer's trade or business, or property held for investment purposes, is exchanged solely for property of a like-kind that is also to be held for productive use in a trade or business or for investment.

The Act provides that, for purposes of the like-kind exchange provision, property which was not identified as the property to be received by the taxpayer on the date the taxpayer relinquishes property, or before the day which is 45 days after that date, does not qualify as like-kind property.

Explanation of Provision

The bill specifies that like-kind property includes property identified as the property to be received by the taxpayer on or before (rather than only before) the date which is 45 days after the date on which the taxpayer relinquishes property.

6. Trust Provisions

a. Multiple trusts (sec. 1806(a) of the bill and sec. 643 of the Code)

Present Law

The Act provides that under Treasury regulation, two or more trusts will be treated as one trust if (1) the trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and (2) a principal purpose for the existence of the trusts in the avoidance of Federal income tax.

This provision is effective for taxable years beginning after March 1, 1984.

Explanation of Provision

The bill provides that this provision is not applicable to any trust which was irrevocable on March 1, 1984, except to the extent corpus is transferred to the trust after that date.

b. Trust distributions (sec. 1806(b) of the bill and sec. 643 of the Code)

Present Law

The Act provides that the basis of property received as a distribution from a trust or estate is to be the basis before the distribution adjusted for gain or loss recognized. An election was provided to recognize gain or loss on the distribution of property from a trust or estate.

Explanation of Provision

The bill clarifies that the election to recognize gain or loss applies to all distributions during a taxable year unless the election is revoked with the consent of the Secretary.

7. Accounting Provisions

a. Settlement funds (sec. 1807(a)(7) of the bill and sec. 461(h) of the Code)

Present Law

The Act provides that liabilities are not treated as incurred prior to the time when economic performance occurs. In the case of the taxpayer's liability to another person, arising under any workers compensation act or any tort, economic performance occurs as payments to such person are made, except to the extent provided in regulations. It is unclear whether an irrevocable payment to a court ordered settlement fund, which extinguishes the tort liability of the taxpayer to a person (or class of persons), constitutes economic performance under the Act.

Explanation of Provision

General rule

The committee bill clarifies that under certain limited circumstances, an irrevocable payment to a court-ordered settlement fund that extinguishes tort liability of the payor (the "taxpayer") constitutes economic performance with respect to such liability. This provision applies only to qualified payments made to a designated settlement fund.

A designated settlement fund means a fund (1) which is established pursuant to a court order, (2) which extinguishes completely the taxpayer's tort liability with respect to a class of claimants, as determined by the court, (3) which is managed and controlled by persons unrelated to the taxpayer, (4) in which the taxpayer does not have a beneficial interest in the income or corpus, and (5) to which no amount may be transferred other than qualified payments.

A qualified payment means cash or property, other than the stock or indebtedness of the taxpayer (or a related party), which is irrevocably contributed to a designated settlement fund pursuant to a court order.

A designated settlement fund is not qualified if the taxpayer may benefit from the corpus or income of the fund. Thus, if the taxpayer's future liability to claimants (or other parties) is contingent on the income of a settlement fund created by the taxpayer, then the taxpayer may benefit from the fund's income, and the fund is not qualified.

A designated settlement fund is taxed as a separate entity at the maximum trust rate. Gross income of a designated settlement fund includes income from investment of fund assets, but excludes qualified payments made to the fund. No deductions are permitted except for certain administrative and incidental expenses. Thus, distributions to claimants are not deductible.

A contribution of property to a designated settlement fund is treated as if the taxpayer sold the property for fair market value and donated the proceeds to the fund. Thus, the taxpayer's deduction is limited to fair market value. The taxpayer recognizes gain or loss at the time property is contributed, and the fund takes a fair market value basis in the property.

No deduction is allowed under this provision for payment to a fund of an amount received from the settlement of an insurance claim, if the amount received is excluded from the taxpayer's gross income.

The bill clarifies that payments to a trust or escrow fund, other than a designated settlement fund, do not constitute economic performance with respect to any tort liability of the taxpayer.

These provisions do not apply to liability arising from any workers compensation act or contested liabilities (within the meaning of section 461(f)); moreover, no inference about the present law treatment of such liabilities is intended.

Transition rule

A corporation that filed a petition for reorganization under chapter 11 of the Bankruptcy Reform Act of 1978 on August 26, 1982,

and which filed with the U.S. Bankruptcy Court a first amended and restated plan of reorganization prior to March 1, 1986, may elect to be taxed under a transition rule. Under the transition rule, a taxpayer may identify a separate account within a trust fund, created by the taxpayer as part of its plan of reorganization, as a designated settlement fund, provided such account meets the requirements of a designated settlement fund. A designated settlement fund created under the transition rule is taxable at a rate of 15 percent (rather than at the maximum trust rates). In addition, the settlement fund's liability shall be assumed by the taxpayer without disqualification of the fund. Such tax liability is treated as a deductible expense of the taxpayer.

Under the transition rule, sale or distribution of the taxpayer's stock by a trust fund (other than by a separate account treated as a designated settlement fund, as described above) is, for purposes of section 1032, treated as a sale or distribution by the taxpayer.

b. Tax shelters (sec. 1807(a)(1) and (2) of the bill and sec. 461(i)(2) of the Code)

Present Law

Generally, a cash basis tax shelter is not allowed a deduction with respect to an amount any earlier than the time at which economic performance occurs. An exception is provided under which prepaid expenses are deductible when paid if economic performance occurs within 90 days after the close of the taxable year. For purposes of this exception, in the case of oil and gas activities, economic performance is deemed to occur with respect to intangible drilling expenses when the well is "spudded." It is unclear whether the exception applies if economic performance occurs before the close of the taxable year, because this is not "within" 90 days after the close of the taxable year. For example, it is unclear whether the exception applies if a well is spudded in the last month of the taxable year.

In the case of the trade or business of farming, the farming syndicate rules of section 464 apply to any tax shelter described in section 6661(b) (i.e., the principal purpose of which is the avoidance or evasion of Federal income tax). For purposes of applying section 464 to these tax shelters, it is unclear whether the exceptions under section 464(c)(2) relating to holdings attributable to active management apply.

Explanation of Provision

The bill clarifies that the 90-day exception applies if economic performance occurs before the close of the 90th day after the close of the taxable year. Thus, for example, if a well is spudded in the last month of the taxable year, the requirement that economic performance occur before the close of the 90th day after the close of the taxable year is satisfied.

The bill also clarifies that any tax shelter described in section 6661(b) will generally be treated as a farming syndicate for purposes of section 464. However, any person meeting the require-

ments of section 464(c)(2) will not be subject to the provisions of section 464 with respect to that person's interest in a tax shelter.

c. Mine reclamation and similar costs (sec. 1807(a)(3) of the bill and sec. 468 of the Code)

Present Law

The Act provided electing taxpayers with a uniform method for deducting, prior to economic performance, certain reclamation costs which are mandated by Federal, State, or local law. Deductions accrued under this method must be accounted for in a book reserve and are subject to recapture to the extent that reclamation costs are less than accumulated reserves.

Explanation of Provision

The bill clarifies that a reserve balance must be increased by the amount of deductions accrued in each year that are allocable to the reserve. The bill also clarifies that this provision is effective for taxable years ending after July 18, 1984.

d. Nuclear power plant decommissioning expenses (sec. 1807(a)(4) of the bill and sec. 468A of the Code)

Present Law

The Act permitted electing taxpayers to accrue a deduction for contributions made to a qualified nuclear decommissioning fund (a "fund"), subject to certain limitations.

Explanation of Provision

The bill clarifies that a taxpayer shall be deemed to have made a payment to a fund at the end of a taxable year provided that payment is made within 2½ months after the close of that taxable year. Under a transitional rule, the Secretary of the Treasury is provided regulation authority to relax, and appropriately adjust, this 2½ month rule for payments allocable to a taxable year beginning before January 1, 1987, and to provide that no interest will be allowed with respect to periods before payment is made. The bill clarifies that the tax treatment of fund income provided in sec. 468A is in lieu of any other Federal income tax, that a fund's tax liability is not deductible from its gross income, and that for purposes of subtitle F ("Procedure and Administration") a fund shall be treated as a corporation and taxes imposed on the fund shall be treated similarly to corporate income taxes. The bill clarifies that a fund may invest only in those assets in which the Code permits a Black Lung Trust Fund to invest. The bill also clarifies that this provision is effective for taxable years ending after July 18, 1984.

e. Treatment of deferred payments for services (sec. 1807(b) of the bill and sec. 467(g) of the Code)

Present Law

Under section 467(g) of the Code, the Secretary of the Treasury is to prescribe regulations under which deferred payments for serv-

ices will be subject to rules similar to those applicable to deferred rents.

Explanation of Provision

The bill clarifies that the regulations to be issued under section 467 relating to deferred payments for services will not apply to amounts to which section 404 or 404A applies, or to amounts subject to any other provision specified in regulations.

In addition, the bill permits a specified taxpayer whose primary business is providing architectural reserves to use the cash method of accounting.

8. Tax Straddle Provisions

a. Treatment of Subchapter S corporations (sec. 1808(a) of the bill)

Present Law

The Act extended the mark-to-market and sixty percent long-term, forty percent short-term capital gain and loss treatment applicable to commodities dealers to dealers in exchange-traded options, provided elections to adopt this treatment for positions carried forward from earlier taxable years into the taxable year including the date of enactment and to pay any increase in tax liability resulting from this election over 5 years, and permitted qualified incorporated commodities dealers and options dealers to elect S corporation status without regard to the requirement of present law that the election be made by the 15th day of the third month of the taxable year for which it is effective.

Explanation of Provision

The bill makes clarifying amendments to ensure that S corporation taxable year limitations do not affect the elections relating to adoption of mark-to-market treatment for positions carried forward from earlier years, and to properly coordinate those elections with the S corporation election with respect to taxable years commencing before January 1, 1984 in the manner provided by regulations.[4]

b. Treatment of amounts received for loaning securities (sec. 1808(b) of the bill and sec. 263(g) of the Code)

Present Law

The present law requirement that interest and other carrying costs incurred to carry personal property constituting part of a straddle must be capitalized, as amended by the Act, limits the requirement to the excess of these costs over interest, discount income and dividend income with respect to the property that is subject to tax during the taxable year. A lender of securities to be used in a short sale may receive compensation from the borrower to replace interest, dividends, and other compensating amounts with respect to the loaned property and may also incur interest

[4] See Treas. Reg. sec. 18.1362-1, 49 Fed. Reg. 38920 (October 1, 1984).

and other carrying costs with respect to the property that are subject to the capitalization requirement.

Explanation of Provision

The bill provides for the inclusion of compensating payments to a lender of securities used in a short sale in those taxable amounts that reduce interest and other costs required to be capitalized under section 263(g) of the Code.

c. Clarification of the exception for straddles consisting of stock (sec. 1808(c) of the bill and sec. 1092(d) of the Code)

Present Law

The Act extended the straddle rules to straddles involving exchange-traded stock options. Exceptions were provided for a straddle consisting of stocks, or stock and a qualified cover call.

Explanation of Provision

The bill clarifies that the exception for stock does not operate to except straddles involving exchange traded stock options (other than qualified covered calls that offset stock).

9. Depreciation Provisions

a. Straight-line election for low-income housing (sec. 1809(a)(1) of the bill and sec. 168 of the Code)

Present Law

Section 111 of the Act extended the recovery period of real property (other than low-income housing) from 15 years to 18 years.[5] Taxpayers may elect to recover the cost of 18-year real property using a straight-line method over the regular 18-year recovery period.

Explanation of Provision

The bill clarifies that taxpayers may elect to recover the cost of low-income housing using a straight-line method over 15 years (but not 18 years).

b. Mid-month convention for real property (sec. 1809(a)(2) of the bill and secs. 57, 168, and 312 of the Code)

Present Law

The Act provided a mid-month convention for the depreciation of 18-year real property (which does not include low-income housing). Under that convention, property placed in service (or disposed of) by a taxpayer at any time during a month is treated as having been placed in service (or disposed of) by the taxpayer in the middle of that month.

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[5] For purposes of this description, 18 year-real property also includes 19-year real property.

Explanation of Provision

The bill clarifies that the mid-month convention is to be applied whenever a depreciation computation with respect to 18-year real property is required under section 168, section 57(a)(12) (relating to accelerated cost recovery deductions as items of tax preference), or section 312(k) (relating to the effect of depreciation on earnings and profits). Thus, for example, if a taxpayer elects under section 168(b)(3) to depreciate 18-year real property on a straight-line basis over 18, 35, or 45 years, the mid-month convention applies in computing the deductions. Similarly, the mid-month conventions applies in determining what cost recovery deductions "would have been allowable" under section 57(a)(12). Numerous conforming changes are also made.

c. Bond-financed 18-year real property (sec. 1809(a)(4) of the bill and sec. 168(f)(12) of the Code)

Present Law

Prior to the Act, section 168(f)(12) placed restrictions on cost recovery allowances with respect to 15-year real property financed by the proceeds of an industrial development bond. Those rules did not apply if the property was placed in service in connection with a project for residential rental property financed by the proceeds of obligations described in section 103(b)(4)(A). The Act generally provided that the cost of real property qualifying as recovery property could not be recovered over a period of less than 18 years.

Explanation of Provision

The bill clarifies that, in general, the cost of 18-year real property (which does not include low-income housing) financed by the proceeds of an industrial development bond cannot be recovered more rapidly than on a straight line basis over 18 years, using a mid-month convention. This rule does not apply if the property is either (i) low-income housing (sec. 168(c)(2)(F)), or (ii) property which is placed in service in connection with a project for residential rental property financed with the proceeds of obligations described in section 103(b)(4)(A) but which is not low-income housing under section 168(e)(2)(F). Costs of the former can be recovered on an accelerated basis under ACRS over 15 years, using a first-of-the month convention, and costs of the latter can be recovered on an accelerated basis under ACRS over 18 years, using a mid-month convention.

d. Treatment of certain transferees of recovery property (sec. 1809(b) of the bill and sec. 168(f)(10) of the Code)

Present Law

A transferee of recovery property generally may elect a recovery period or method for the property different from the period or method elected by the transferor. However, restrictions are imposed by section 168(f)(10) to prevent the use of certain kinds of asset transfers as a means to change the recovery period or method for the property involved. For transfers subject to those restrictions, the transferee must "step into the shoes" of the transferor

with respect to so much of the transferee's basis in the property as is not in excess of the property's adjusted basis in the hands of the transferor. Under this rule, the transferee's cost recovery deductions with respect to that basis are the same as those that would have been allowed the transferor had no transfer occurred. The transferee can elect to depreciate any excess basis pursuant to any recovery period or method available under the general rules.

Asset transfers subject to the rule of the preceding paragraph include sale-leasebacks (sec. 168(f)(10)(B)(iii)), transfers between related persons (sec. 168(f)(10)(B)(ii)), and tax-free asset (carryover basis) transfers described in section 332, 351, 361, 371(a), 374(a), 721, or 731 (sec. 168(f)(10)(B)(i)).

Explanation of Provision

In cases described in sections 168(f)(10)(B)(ii) and (iii) of present law, the "step into the shoes" rule is often too generous to the transferee. The rule has the general effect of permitting such a transferee higher cost recovery deductions than would have been allowed to a transferee in a case not covered by either section. Furthermore, the Act, in amending the rules regarding the depreciation of real property (other than low-income housing) qualifying as recovery property, did not clearly provide how section 168(f)(10) would apply.

The bill amends section 168(f)(10) with respect to recovery property placed in service by the transferor. In a case described in section 168(f)(10)(B)(ii) or (iii) (but not (i)) of present law, the transferee does not "step into the shoes" of the transferor. Instead, the transferee starts depreciating the property as would any other new owner of it. However, to the extent of the adjusted basis of the property in the hands of the transferor, the transferee is treated as having made any election made by the transferor with respect to the property under section 168(b)(3) or section 168(f)(2)(C). Thus, for example, if the transferor had elected to depreciate 5-year property on a straight-line basis over 5 years, a transferee under section 168(f)(10)(B)(ii) or (iii) would be treated as having made the same election to the extent basis did not increase. Furthermore, the transferee would begin depreciating that basis in the year of the transfer over a new 5-year period. For purposes of this rule, if the transferor was depreciating 15-year real property on a straight-line basis, the transferee would be treated as having elected 18-year straight line depreciation. If the transferee's basis exceeded the transferor's adjusted basis, the transferee can depreciate the excess under the general rules. The bill is not intended to affect the treatment of transactions between members of an affiliated group of corporations filing a consolidated return.

With one exception, the bill does not amend section 168(f)(10)(B)(i). Thus, for example, in a section 351 transaction, the transferee steps into the transferor's shoes to the extent basis does not increase. However, the bill amends section 168(f)(10)(B)(i) to provide that it does not apply in the case of the termination of a partnership under section 708(b)(1)(B) (relating to the sale or exchange of 50 percent or more of the total interest in a partnership's capital and profits within a 12-month period).

The amendments generally apply to property placed in service by the transferee after March 1, 1986.

e. Films, videotapes, and sound recordings (sec. 1809(c) of the bill and sec. 167 of the Code)

Present Law

Under the Act, films and videotapes cannot qualify as recovery property (sec. 168(e)(5)). Similarly, sound recordings do not qualify as recovery property unless an election is made under section 48(r)(1) (relating to treating a sound recording as 3-year property). Thus, their costs cannot be recovered under ACRS. If a film or videotape, or a sound recording, not qualifying as recovery property qualifies as tangible property, however, its costs may be recoverable under depreciation methods prescribed by section 167(b) (e.g., a declining balance method).

Explanation of Provision

Under the bill, films, videotapes, and sound recordings are not eligible for the accelerated depreciation methods available under section 167(b)(2), (3), or (4). However, the income forecast method or similar methods of depreciation are available.

The provision applies to films, videotapes, and sound recordings placed in service by the taxpayer after March 28, 1985. However, no inference is intended as to whether or not films, videotapes, or sound recordings, placed in service by a taxpayer on or before that date qualify for these accelerated depreciation methods.

f. Investment tax credit (sec. 1809(d) of the bill and sec. 48 of the Code)

Present Law

The Act amended the 3-month rule of section 48(b) (relating to whether property qualifies as new section 38 property). Under the Act, rules relating to the qualification of certain property reconstructed by the taxpayer as new section 38 property were inadvertently deleted.

Explanation of Provision

The bill reinstates the provision that section 38 property the reconstruction of which is completed by the taxpayer qualifies as new section 38 property. The bill also provides that the 3-month rule is not applicable to section 38 property the reconstruction of which is completed by the taxpayer. Thus, property reconstructed by a taxpayer and then sold and leased back by the taxpayer within 3 months of the date actually placed in service is to be treated as placed in service on the date actually placed in service.

The bill also clarifies the applicability of the 3-month rule in the case of certain sale-leasebacks. Thus, assume that taxpayer A places eligible property in service by leasing it to taxpayer B. Assume further that, within 3 months of the date A placed the property in service, A sells the property to taxpayer C and taxpayer C leases the property back to A, subject to the lease to B. As-

suming C's lease to A qualifies as a lease under applicable Code principles, the property will constitute new section 38 property in C's hands. The amendment clarifies that this result would occur under the prior statutory language.

Under the bill, the 3-month rule does not apply if the lessee and lessor so elect.

10. Foreign Provisions

a. Maintaining the source of U.S. source income (sec. 1810(a) of the bill and sec. 904(g) of the Code)

Present Law

Prior to the Act, a U.S. taxpayer could convert U.S. source income to foreign source income by routing the income through a foreign corporation: Interest and dividend payments from (and income inclusions with respect to) an intermediate foreign corporation generally were foreign source income to the U.S. taxpayer. As foreign source income, the income could be free of U.S. tax under the foreign tax credit.

The Act added to the foreign tax credit rules new rules that prevent U.S. taxpayers from converting U.S. source income into foreign source income through the use of an intermediate foreign payee. These rules apply to 50-percent U.S.-owned foreign corporations only. These rules do not apply if less than 10 percent of the foreign corporation's earnings and profits is from U.S. sources.

Interest and dividends paid by a domestic corporation that earns less than 20 percent of its gross income from U.S. sources over a three-year period (an "80/20 company") are foreign source (Code secs. 861(a)(1)(B) and 861(a)(2)(A)). Therefore, a U.S. taxpayer can convert U.S. source income to foreign source income by routing it through an 80/20 company, as long as the company's U.S. source gross income remains below the 20-percent threshold.

The Act provides a transitional rule for certain interest received by "applicable CFCs." The Act defines an "applicable CFC" as any controlled foreign corporation in existence on March 31, 1984, the principal purpose of which on that date consisted of issuing CFC obligations or holding short-term obligations and lending the proceeds to affiliates. The Act provided that, if certain requirements are met, interest paid to an applicable CFC on a U.S. affiliate obligation issued before June 22, 1984 (the date of conference action) will be treated for all Code purposes as paid to a resident of the country in which the applicable CFC is incorporated. This rule exempts from the resourcing provisions interest paid by a U.S. affiliate on certain obligations issued before the effective date of the amendment by a U.S.-owned finance subsidiary located in the Netherlands Antilles.

A U.S. affiliate obligation is any obligation of a U.S. person related (within the meaning of Code section 482) to an applicable CFC holding the obligation. Interest paid on an obligation of a foreign person is not subject to the source maintenance rules.

Under the U.S. Constitution, the more recently adopted of a conflicting treaty and statute generally takes precedence. Thus, a treaty ratified in the future that contains its own source rules ar-

guably might override the source maintenance rules. A preexisting treaty containing such rules would not do so under the constitutional rule. While under a Code provision in effect since 1936, some statutory taxing rules in effect yield to preexisting treaties, this Code rule applies only in the case of a treaty exclusion from gross income; treaty source rules are not exclusions from gross income. Consistent with these general rules, Congress intended that the new rules maintaining the source of U.S. source income take precedence over any conflicting U.S. treaty provisions in force when it enacted the Act. Congress also intended that the source maintenance rules take precedence over any conflicting U.S. treaties entered into in the future, absent an express intention in the treaty to override the rules. Some argue that certain U.S. treaties awaiting ratification may conflict with the source maintenance rules.

Explanation of Provision

Under the bill, an 80/20 company will be treated as a U.S.-owned foreign corporation and thus will be subject to the rules maintaining the source of U.S. source income. The bill thereby prevents U.S. taxpayers from using 80/20 companies to convert U.S. source income to foreign income.

This provision generally will take effect on March 28, 1985. In the case of any taxable year of an 80/20 company ending after March 28, 1985, only income received or accrued by the 80/20 company during that portion of the taxable year after that date generally is to be taken into account for purposes of the new source maintenance rules. However, all income received or accrued by the 80/20 company during that taxable year is to be taken into account in determining whether the 10 percent U.S. source earnings and profits threshold for the source maintenance rules is exceeded.

The bill clarifies the applicable CFC definition. Under the bill, an applicable CFC is any controlled foreign corporation in existence on March 31, 1984, the principal purpose of which on that date consisted of (1) any combination of issuing CFC obligations and short-term borrowing from nonaffiliated persons and (2) lending the proceeds to affiliates.

The bill provides that certain U.S. source interest paid to an applicable CFC by an affiliated foreign corporation on an obligation of that corporation issued before June 22, 1984, will be subject to the resourcing provisions to the same extent that interest so paid by an affiliated U.S. corporation would be so subject. This treatment applies if at least 50 percent of the foreign corporation's gross income for the three-year period ending on or before March 31, 1984, and with the close of its taxable year preceding the payment of the interest in question, was effectively connected with a U.S. trade or business.

The bill makes clear that the source maintenance rules apply notwithstanding any contrary U.S. treaty obligation, even those entered into after the Act's date of enactment, unless the treaty clearly expresses an intent to override the rules by specific reference to them. Although the committee finds it appropriate to clarify the relation between the source maintenance rules of the Act and the treaty obligations of the United States, no inference con-

trary to the general rule that gives precedence to the provisions of the Act over preexisting treaty provisions should be drawn with respect to any other provision of the Act (except as specifically provided in the Act or its legislative history). In enacting the 1984 Act, Congress specifically provided that treaties were to prevail over certain statutory rules that apply to stapled stock and to the definition of residence of individuals; with these two exceptions, the committee is not aware of conflicts between the 1984 Act and treaties where the Act would not clearly take precedence. For example, it is the committee's understanding that changes made by the Act in the accumulated earnings tax provisions override a conflicting provision in the U.S. income tax treaty with Jamaica.

b. Maintaining the character of interest income (sec. 1810(b) of the bill and sec. 904(d)(3) of the Code)

Present Law

In general

The Act provided that when a U.S. taxpayer includes in income foreign personal holding company or subpart F income with respect to (or an interest or dividend payment from) a designated payor corporation that has earned substantial "separate limitation interest" (generally passive interest income), that inclusion or payment will generally constitute interest that is subject to the separate foreign tax credit limitation for interest income.

The purpose of this look-through rule is to prevent U.S. taxpayers from using foreign corporations to inflate the overall foreign tax credit limitation. Prior to the Act, U.S. taxpayers could arguably circumvent the separate foreign tax credit limitation for interest income by having low-taxed interest income paid to a foreign corporation rather than directly to them. Subpart F and foreign personal holding company inclusions with respect to the foreign corporation, and dividends and interest received from the foreign corporation, were treated as noninterest income of the U.S. taxpayers that was subject to the overall foreign tax credit limitation. As a result of an easily manipulable financial transaction, the conversion of interest income to noninterest income was possible.

Definition of designated payor corporation

The Act generally defines a designated payor corporation as any regulated investment company, 50-percent (or more) U.S.-owned foreign corporation, or foreign corporation with a ten-percent U.S. shareholder. A domestic corporation that pays foreign source dividends can be a designated payor corporation only if it is a regulated investment company.

A domestic company's dividends (and interest payments) are foreign source if it is an "80/20" company, that is, if it earns less than 20 percent of its gross income from U.S. sources for a three-year period (Code secs. 861(a)(1)(B) and 861(a)(2)(A)).

Code section 269 denies tax benefits to taxpayers who acquire control of corporations to avoid or evade tax. The extent to which section 269 applies to defeat schemes to avoid the Act's look-through rules by using U.S. or foreign corporations is not clear.

10-percent exception

The Act contains a de minimis rule that prevents characterization of inclusions and payments as interest subject to the separate foreign tax credit limitation for interest income unless 10 percent or more of the earnings and profits of the designated payor corporation is attributable to separate limitation interest. This de minimis rule applies even in the case of income inclusions that arise under the anti-avoidance rules that apply to foreign personal holding companies and controlled foreign corporations.

Related party interest

The Act provided that when a designated payor corporation receives interest from another member of the same affiliated group, the interest shall not be treated as separate limitation interest unless the interest is attributable (directly or indirectly) to separate limitation interest of the other member.

Working capital exception

Prior to the Act, investments of working capital in a regulated investment company with foreign earnings generated foreign source dividend income that was not subject to the separate limitation for interest. Under the Act, such dividend payments may be recharacterized as interest payments subject to the separate limitation for interest. Prior to the Act, certain interest earned on working capital-type investments was excluded from the separate limitation regardless of from whom received: interest was not subject to the separate limitation if derived from any transaction which was directly related to the active conduct by the taxpayer of a trade or business in a foreign country or a U.S. possession (Code sec. 904(d)(2)(A)). The Act does not allow this working capital exception at the shareholder level for interest received from a regulated investment company or other designated payor corporation by its shareholders. Under the Act, this working capital exception and the 10-percent de minimis exception referred to above are available at the designated payor corporation level only. Since regulated investment companies earn primarily passive investment income, their income typically cannot qualify for these exceptions. Therefore, dividends paid by regulated investment companies generally are treated as interest subject to the separate limitation to the extent that the regulated investment company earns separate limitation interest, whether the recipient shareholder's investment is one of working capital or not.

Explanation of Provisions

Definition of designated payor corporation

The bill amends the definition of designated payor corporation in two respects.

First, the bill makes clear that any corporation formed or availed of for purposes of avoiding the look-through rule will be treated as a designated payor corporation subject to the rule. For example, U.S. taxpayers will not be permitted, in violation of the purpose of the look-through rule, to convert interest income to noninterest

income by earning the income through a corporation the ownership of which is structured to place the corporation technically outside the present law definition of designated payor corporation: a foreign corporation that earns sufficient earnings and profits attributable to separate limitation interest to be subject to the look-through rule, but is majority-owned by foreign persons and has no ten-percent U.S. shareholders, will be treated as a designated payor corporation (regardless of the original purpose for its formation) if U.S. shareholders utilize the corporation to remove interest income from the separate foreign tax credit limitation for interest income. Similarly, U.S. taxpayers will not be permitted, in violation of the purpose of the look-through rule, to convert interest income to non-interest income by earning the income through a foreign banking subsidiary or similar entity formed or availed of for that purpose. (Absent this anti-abuse rule, interest earned by a taxpayer in the conduct of a banking or similar business would not be subject to the separate foreign tax credit limitation for interest.) The Secretary may promulgate regulations setting forth appropriate rules for determining whether a corporation has been formed or availed of for purposes of avoiding the look-through rule.

Second, the bill expands the definition of designated payor corporation to include any 80/20 company. By subjecting 80/20 companies to the look-through rule, the bill prevents U.S. taxpayers from using 80/20 companies to circumvent the separate foreign tax credit limitation for interest income.

The first described amendment to the designated payor corporation definition generally takes effect on December 31, 1985. The second described amendment to the designated payor corporation definition generally takes effect on March 28, 1985. In the case of any taxable year of a corporation treated as a designated payor corporation by virtue of these amendments ending after the indicated date, only income received or accrued by the corporation during that portion of the taxable year after that date generally is to be taken into account for purposes of the look-through rule. However, all income received or accrued by the corporation during that taxable year is to be taken into account in determining whether the ten-percent earnings and profits threshold for dividends and interest is exceeded. A corporation formed on or before December 31, 1985, but availed of after that date to avoid the look-through rule, will be subject to the rule.

10-percent exception

Consistent with the Act's rules for source maintenance, the bill removes the Act's de minimis rule that prevents maintenance of the character of interest income in the case of foreign personal holding company inclusions and Subpart F inclusions.

Related party interest

The bill makes it clear that when a designated payor corporation receives dividends or interest from another member of the same affiliated group, the amount shall be treated as separate limitation interest if (and only if) the amount is attributable (directly or indirectly) to separate limitation interest of the other member (or any other member of the group).

Working capital exception

Under the bill, dividends and interest received from a regulated investment company by a portfolio shareholder in such company will not be treated as interest subject to the separate limitation for interest if derived from any transaction which is directly related to the active conduct by the shareholder of a trade or business in a foreign country or a U.S. possession. A portfolio shareholder for this purpose is one that owns, directly or indirectly, less than 10 percent of the voting stock of the regulated investment company.

c. Related person factoring income (sec. 1810(c) of the bill and secs. 864 and 956 of the Code)

Present Law

Investment in U.S. property

Under present and prior law, the Code treats an investment in United States property by a controlled foreign corporation as an effective repatriation of the amount invested and thus as a dividend. The Act provided that "United States property" includes any trade or service receivable acquired fom a related U.S. person if the obligor under the receivable is a U.S. person. This provision overrode exceptions (listed in Code sec. 956(b)(2)) to the investment in U.S. property rules. Among those exceptions is an exclusion from U.S. property of an amount of assets equal to post-1962 earnings and profits previously excluded from subpart F income on the ground that the United States had already subjected those amounts to tax directly as effectively connected income (sec. 956(b)(2)(H)).

Current inclusion of factoring income

The Act provided that if any person acquires a trade or service receivable from a related person, the acquirer's income from the receivable is treated as interest on a loan to the obligor under the receivable. In general, this income is currently taxable to the owners of the acquirer of the receivable under the foreign personal holding company rules or the controlled foreign corporation rules (subpart F). The income is currently taxable even when the related person that acquires the receivable acquires it from an entity that is organized under the laws of the same foreign country as the acquirer and that has a substantial part of its assets used in its trade or business located in that same country.

Separate limitation treatment

Related person factoring income is treated under the Act as interest described in section 904(d)(2) and, therefore, is subject to the separate foreign tax credit limitation for interest. Congress intended that this income be ineligible for any exception to application of the separate limitation. However, the Act does not include in its enumeration of the exceptions the affiliated group exception to the Act's rules maintaining the character of interest income (section 904(d)(3)(J)).

Explanation of Provisions

Investment in U.S. property

The bill provides that the existing exclusion from U.S. property of an amount of assets equal to the controlled foreign corporation's post-1962 earnings and profits excluded from subpart F income as taxable effectively connected income will apply in the case of the acquisition of a trade or service receivable that otherwise constitutes U.S. property.

Current inclusion of factoring income

The bill generally exempts factoring income from current inclusion when the related person that acquires the factored receivable acquires it from an entity that is organized under the laws of the same foreign country as the acquirer and that has a substantial part of its assets used in its trade or business located in that same country. Factoring income is still subject to the current inclusion rule, however, if the person transferring the receivable would have derived any foreign base company income (determined without regard to the 10-percent exception) or income that is effectively connected with a U.S. trade or business had it collected the receivable.

For example, assume that a controlled foreign corporation manufactures a product in the foreign country of its incorporation and sells the product to an unrelated customer in exchange for the customer's receivable. None of the manufacturer's income from this sale is effectively connected with a U.S. trade or business, and none of it would be currently taxable to its U.S. shareholders. The manufacturer sells the receivable to a related controlled foreign corporation that is organized under the laws of the same foreign country. Under the bill, the income of the acquirer from that receivable is not subject to current U.S. taxation.

By contrast, assume that another controlled foreign corporation purchases goods from its U.S. parent and resells those goods to a customer (in exchange for the customer's receivable) for use outside the country of incorporation of the controlled foreign corporation. This income would be currently taxable to the U.S. shareholders of the controlled foreign corporation as foreign base company sales income under the subpart F rules (sec. 954(d)). The controlled foreign corporation sells the receivable to a related controlled foreign corporation that is organized under the laws of the same foreign country as the seller. Under the bill, the income of the acquirer from the receivable remains subject to current taxation at the level of its U.S. shareholders.

The bill's treatment of factoring income also extends to income from analogous loans by a controlled foreign corporation to finance transactions with related parties.

Separate limitation treatment

The bill provides that related person factoring income treated under the Act as interest is subject to the separate limitation for interest without regard to the exception to the definition of separate limitation interest for certain interest received from members of the same affiliated group.

d. Repeal of 30-percent withholding tax on portfolio interest paid to foreign persons (secs. 1810 (a) and (d) of the bill and secs. 871, 881, 1441, and 1442 of the Code)

Present Law

In general

The United States generally imposes a flat 30-percent withholding tax on the gross amount of U.S. source investment income payments to foreign persons. The Act repealed the 30-percent tax with respect to portfolio interest paid on certain indebtedness by U.S. borrowers to nonresident alien individuals and foreign corporations. This exemption from the 30-percent tax is effective for interest paid on qualifying obligations issued after July 18, 1984, the date of enactment of the Act.

Registered obligations—non-U.S. person statement

The Act repealed the 30-percent tax with respect to interest paid on obligations issued in registered form for which the U.S. payor (or U.S. person whose duty it would otherwise be to withhold tax) receives a statement that the beneficial owner of the obligation is not a U.S. person.

Interest received by controlled foreign corporations

Interest received by a controlled foreign corporation ("CFC") from a person other than a related person may be exempt from the 30-percent tax under the Act. To prevent U.S. persons from indirectly taking advantage of the exemption, however, the Act provides that portfolio interest received by a CFC is includible in the gross income of the CFC's U.S. shareholders under subpart F without regard to any of the exceptions otherwise provided under the subpart F rules.

It appears that some interest paid by foreign corporations, which would not have been subject to the 30-percent tax prior to the Act, nonetheless may fall within the technical definition of portfolio interest. Where such interest is paid to a CFC, treatment of the interest as portfolio interest may subject it to current taxation under subpart F without regard to any of the subpart F exceptions.

Interest received by 10-percent shareholders—attribution rules

Congress did not extend the repeal of the 30-percent tax to interest paid to foreign persons having a direct ownership interest in the U.S. payor because the combination of U.S. deduction and noninclusion in such a case would have created an incentive for interest payments that Congress did not believe appropriate.

A direct ownership interest, for these purposes, generally means a 10-percent (or greater) ownership interest in the U.S. payor. In determining whether direct ownership exists, the stock ownership attribution rules of the Code apply, with certain modifications (sec. 318(a)). One of the applicable attribution rules is that a corporation generally is deemed to own stock that its 50-percent—(or greater) owned subsidiary owns in proportion to the corporation's share of its subsidiary's stock (sec. 318(a)(2)(C)). In determining whether direct ownership exists for purposes of the repeal, this rule is ap-

plied without regard to the 50-percent limitation. This modification in the attribution rule prevents an affiliated group of corporations from circumventing the direct ownership exception to the 30-percent tax repeal by, for example, having a U.S. member pay interest to the 49-percent foreign owner of the U.S. member's foreign parent, rather than directly to that foreign parent.

Another of the applicable attribution rules is that a 50-percent—(or greater) owned subsidiary generally is deemed to own the stock that its parent owns (sec. 318(a)(3)(C)). The Act applies this rule in determining whether direct ownership exists for purposes of the repeal without any modification of the 50-percent limitation. This allows an affiliated group of corporations to circumvent the direct ownership exception to the 30-percent tax repeal by having a U.S. member pay interest to an affiliated foreign corporation that is as much as 49-percent-owned by a substantial foreign shareholder in the U.S. member, rather than directly to that substantial shareholder.

Explanation of Provisions

Registered obligations—non-U.S. person statement

The bill clarifies that the beneficial owner of a registered obligation, the interest on which is otherwise eligible for the repeal, may claim a refund of any tax withheld where the required non-U.S. person statement is provided after one or more interest payments are made rather than before. Claims for such refunds are subject to the general statute of limitations rules for refund claims (sec. 6511).

Interest received by controlled foreign corporations

The bill amends the definition of portfolio interest to exclude interest that (without regard to the operation of treaties) would not have been subject to the 30-percent tax prior to the Act. Thus, under the bill, interest received by CFCs will be denied the benefit of any otherwise applicable subpart F exceptions only if the interest would have been subject to the 30-percent tax in the absence of the repeal provision.

Interest paid to 10-percent shareholders—attribution rules

In determining whether the direct ownership exception to the 30-percent tax repeal applies, the stock ownership attribution rule of Code section 318(a)(3)(C) will apply without regard to its 50-percent ownership limitation. Where the attribution rule would not apply but for the disregard of the 50-percent limitation, a foreign interest recipient will be treated as owning the stock its foreign shareholder owns in proportion to that shareholder's ownership interest in the foreign interest recipient.

e. Original issue discount—foreign investors

(1) Deduction for original issue discount (sec. 1810(e)(1) of the bill and sec. 163 of the Code)

Present Law

The Act delayed until actual payment the deduction for interest accrued, but not paid, to related foreign lenders with respect to an original issue discount (OID) obligation.

Explanation of Provision

The bill provides that the delay in the timing of deductions for interest accrued but not paid to related foreign lenders with respect to an OID obligation does not apply to the extent that the OID income is effectively connected with the lender's conduct of a U.S. trade or business, unless the OID income is exempt from U.S. taxation or is subject to a reduced rate of tax pursuant to a treaty obligation of the United States.

(2) Taxation of original issue discount (sec. 1810(e)(2) of the bill and secs. 871 and 881 of the Code)

Present Law

Under the Act, a foreign investor that receives a taxable interest payment on an OID obligation is taxable on an amount equal to the OID accrued on the obligation since the last payment of interest thereon. On the sale, exchange, or retirement of an OID obligation, the foreign investor is taxable on the amount of any gain not in excess of the OID accruing while the foreign investor held the obligation (to the extent not previously taxed).

Explanation of Provision

The bill provides that when a foreign investor receives a payment (whether constituting interest or principal) on an OID obligation, the amount taxable is equal to the OID accrued on the obligation that has not before been subject to tax, whether or not the OID accrued since the last payment of interest. On the sale, exchange, or retirement of an OID obligation, the foreign investor is taxable on the amount of the OID accruing while the foreign investor held the obligation (to the extent not previously taxed), whether or not that amount exceeds the foreign investor's gain on the sale, exchange, or retirement.

f. Withholding on dispositions by foreigners of U.S. real property interests (sec. 1810(f) of the bill and secs. 897, 1445, 6039C, and 6652(g) of the Code)

Present Law

In general

Under the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA), a foreign investor that disposes of a U.S. real property interest generally is required to pay tax on any gain on the disposi-

tion. FIRPTA provided for enforcement of this tax through a system of information reporting designed to identify foreign owners of U.S. real property interests.

The 1984 Act generally repealed the information reporting requirements of FIRPTA and established a withholding system to enforce the FIRPTA tax.[6] The Act imposes a withholding duty on a transferee of a U.S. real property interest from a foreign person unless the transferee receives a sworn affidavit stating that the transferor is not foreign ("non-foreign affidavit"), or one of four other withholding exemptions (some of which are discussed in more detail below) applies. The amount withheld generally is the lesser of ten percent of the amount realized (purchase price), or the maximum tax liability on disposition (as determined by the IRS). Special rules are provided (some of which are discussed further below) for withholding by partnerships, trustees, executors, distributing foreign corporations, and domestic U.S. real property holding corporations.

Corporations making section 897(i) election

The Act does not treat foreign corporations electing under Code section 897(i) to be considered domestic corporations for purposes of FIRPTA's substantive and reporting provisions as domestic corporations for withholding purposes. This was intended to simplify the non-foreign affidavit procedure. If the section 897(i) election were applicable for withholding purposes, then electing foreign corporations could provide non-foreign affidavits. Congress was concerned that there would be uncertainty on the part of U.S. buyers regarding the validity of non-foreign affidavits received from foreign corporations.

Since enactment of the Act, the Internal Revenue Service has developed a procedure that would provide U.S. buyers with reasonable assurance that a non-foreign affidavit received from a foreign corporation is valid (as a result of a valid section 897(i) election) (Temp. Reg. secs. 1.1445–2T(b)(2)(ii), 1.1445–5T(b)(3)(ii)(C), and 1.1445–7T(a)).

Withholding exemptions for transfers of stock in domestic corporations

Withholding is not required on the disposition of an interest (other than an interest solely as a creditor) in a nonpublicly traded domestic corporation if the corporation furnishes a sworn affidavit to the transferee stating that the corporation is not and has not been a U.S. real property holding corporation ("U.S. RPHC") during the base period specified in Code section 897(c)(1)3(A)(ii)—the shorter of the period after FIRPTA's general effective date (June 18, 1980) during which the transferor held the interest and the five-year period ending on the date of disposition of the interest ("non-U.S. RPHC affidavit"). The receipt of a non-U.S. RPHC affidavit will not relieve the transferee of withholding responsibility if

[6] The Act does authorize the Secretary of the Treasury to require information reporting by foreign investors not engaged in a U.S. business that hold direct investments in U.S. real property of $50,000 or more. The Secretary has not exercised that authority and has expressed a current intention not to require information reporting.

the transferee has actual knowledge that the affidavit is false or the transferee receives a notice from his or her agent or an agent of the transferor that the affidavit is false.

In addition, no withholding is required on a disposition of shares of a class of corporate stock that is regularly traded on an established securities market.

Notice-giving and withholding responsibilities of agents

A transferor's agent or transferee's agent with actual knowledge that a non-foreign or non-U.S. RPHC affidavit is false must give the transferee notice to that effect at such time and in such manner as the Secretary shall require by regulations. In the case of a foreign corporate transferor, an agent of the transferor is deemed to have actual knowledge that any non-foreign affidavit furnished by the transferor is false. Congress believed that any agent deriving compensation from a foreign corporate principal in a real estate transaction would or should know that his or her principal was in fact foreign and that any non-foreign affidavit furnished by the foreign corporation was, therefore, false. In a case involving the transfer by a foreign corporation of stock in a domestic corporation that furnishes a false non-U.S. RPHC affidavit, it was not Congress' intention that an agent of the foreign corporate transferor be charged with actual knowledge of the non-U.S. RPHC affidavit's falsity, absent actual possession of such knowledge.

A transferor's agent or transferee's agent that does not give the required notice is liable for withholding as if he or she were the transferee, up to the amount of compensation the agent receives in connection with the transaction.

Dispositions of U.S. real property interests by domestic partnerships, trusts, and estates

The Act requires withholding at a ten-percent rate by a domestic partnership, a trustee of a domestic trust, or an executor of a domestic estate with respect to amounts in the custody of the partnership, trust, or estate that are attributable to the disposition of a U.S. real property interest and includible in either the distributive share of a foreign partner of the partnership, the income of a foreign beneficiary of the trust or estate, or the income of the grantor or other substantial owner of the trust (under the grantor trust rules of the Code).

Distributions by domestic U.S. RPHC's

The Act generally requires withholding by a domestic corporation that is (or, at any time during the five-year or shorter base period specified in Code section 897(c)(1)(A)(ii), was) a U.S. RPHC when the corporation distributes property to a foreign shareholder in a corporate liquidation or in redemption of its stock. In general, the amount of tax required to be withheld is ten percent of the gross amount of the distribution received by the foreign shareholder.

Withholding is not required under this rule when the stock liquidated or redeemed qualifies for the withholding exemption for stock transferred on an established securities market. Stock qualifying for that exemption may not be a U.S. real property interest

and, hence, its surrender may not be a taxable disposition under the FIRPTA rules.

In addition, a qualifying statement granting exemption from withholding under this rule may be requested from the Internal Revenue Service in connection with a liquidating distribution by a domestic corporation of a non-U.S. real property interest when Code section 337 nonrecognition treatment was not elected for related corporate-level dispositions of U.S. real property interests (made during the base period specified in Code section 897(c)(1)(A)(ii)) by the domestic corporation. If the section 337 election was not made, the related corporate-level dispositions would have been subject to tax; a foreign shareholder's interest in the liquidating corporation may not be a U.S. real property interest (under the Code section 897(c)(1)(B) rule excluding from the definition of a U.S. real property interest an interest in a corporation that is not currently holding U.S. real property interests and that was fully taxed on previous corporate-level dispositions of such interests during the section 897(c)(1)(A)(ii) base period). Thus, the foreign shareholder's surrender of his interest in the corporation may not be a taxable disposition under the FIRPTA rules.

Taxable distributions by partnerships, trustees, and executors

The Act requires withholding by a domestic or foreign partnership, the trustee of a domestic or foreign trust, or the executor of a domestic or foreign estate when the partnership, trustee, or executor makes a distribution of a U.S. real property interest to a foreign person that is a taxable distribution under the FIRPTA rules taxing certain partnership, trust, and estate distributions notwithstanding general Code rules. In general, the amount of tax required to be withheld is ten percent of the fair market value of the distributed U.S. real property interest at the time of the distribution.

As drafted, this rule technically would apply only to U.S. real property distributions taxable under regulations promulgated pursuant to Code section 897(g). The statute makes no reference to another Code provision added by FIRPTA—section 897(e)(2)(B)—under which certain partnership, trust, and estate distributions not covered by section 897(g) could be treated as taxable sales by regulation.

Return-filing and remittance of tax

To prevent double taxation, the Economic Recovery Tax Act of 1981 directs a person subject to tax under the FIRPTA rules to pay the tax to and file the necessary returns with the United States in the case of real property interests located in the United States, and to pay the tax to and file the necessary returns with the Virgin Islands in the case of real property interests located in the Virgin Islands. A sale of an interest, other than solely as a creditor, in a U.S. RPHC is subject to tax in the United States, while the tax on a sale of an interest in a Virgin Islands real property holding corporation is payable to the Virgin Islands.

Information returns—penalty provision

The FIRPTA information reporting rules include a provision imposing penalties on persons that fail to file required FIRPTA infor-

mation returns and statements (Code sec. 6652(g)). As indicated above, the 1984 Act limited the circumstances under which the Secretary could require information reporting. The Act did not, however, make necessary conforming changes in the penalty provision.

Explanation of Provisions

Corporations making section 897(i) election

Under the bill, a foreign corporation electing under section 897(i) to be treated as a domestic corporation for purposes of FIRPTA's substantive and reporting provisions will be treated as a domestic corporation for purposes of the FIRPTA withholding provisions too.

The bill also provides that the section 897(i) election will be the exclusive remedy for any person claiming discriminatory treatment under a treaty obligation of the United States with respect to the FIRPTA withholding provisions.

Withholding exemptions for transfers of stock in domestic corporations

The bill conforms the non-U.S. RPHC withholding exemption more closely to the underlying substantive tax rule by substituting for it a new "non-U.S. real property interest" exemption to reflect Code section 897(c)(1)(B). Under the bill, withholding is not required on the disposition of an interest (which is an interest other than solely as a creditor) in a nonpublicly traded domestic corporation if the corporation furnishes an affidavit to the transferee stating, under penalty of perjury, either that the corporation is not and has not been a U.S. RPHC during the base period specified in Code section 897(c)(1)(A)(ii), or that, as of the date of the disposition, interests in the corporation are not U.S. real property interests by reason of section 897(c)(1)(B). Under section 897(c)(1)(B), interests in a corporation are not U.S. real property interests if the corporation is not holding any U.S. real property interests at the time of the disposition of the corporate interests and if the corporation disposed of all U.S. real property interests it held during the section 897(c)(1)(A)(ii) base period in transactions in which the full amount of gain (if any) was recognized.

The present law rules governing notice-giving by agents and withholding by agents and transferees in the case of a false non-U.S. RPHC affidavit will control (with the clarification discussed below) in the case of a false non-U.S. real property interest affidavit.

Notice-giving and withholding responsibilities of agents

The bill clarifies that an agent of a foreign corporate transferor of a domestic corporation's stock will not be charged with actual knowledge of the falsity of a false non-U.S. real property interest affidavit (the bill's substitute for the Act's non-U.S. RPHC affidavit) furnished by the domestic corporation, absent actual possession of such knowledge. Thus, no notice-giving or withholding duty will be imposed on such a transferor's agent unless he or she actually knows that the non-U.S. real property interest affidavit is false. An agent of a foreign corporate transferor will be charged with knowl-

edge of the falsity only of a false non-foreign affidavit furnished by his or her principal.

It should be noted that, under the bill, unlike the Act, a non-foreign affidavit furnished by a foreign corporation may be valid. This will be the case where the foreign corporation has elected to be treated as a domestic corporation under Code section 897(i) and the corporation provides the transferee with proof of the section 897(i) election in the manner specified in regulations.

Dispositions of U.S. real property interests by domestic partnerships, trusts, and estates

The bill modifies the special withholding rule for dispositions of U.S. real property interests by domestic partnerships, trusts, and estates. Under the bill, a domestic partnership, a trustee of a domestic trust, or an executor of a domestic estate is to withhold a tax equal to 28 percent of the gain realized on the disposition by the entity of a U.S. real property interest, to the extent that gain is allocable to a foreign partner or foreign beneficiary of the partnership, trust, or estate or, in the case of a trust, is allocable to a portion of the trust treated as owned by a foreign person under the grantor trust rules of the Code. (It is intended that the Secretary of the Treasury will, by regulations, provide an exception from withholding with respect to gain realized on the disposition of a U.S. real property interest by a trust or estate that is currently taxable at the entity level.)

Consistent with the Act's general withholding rule, withholding liability under this special rule, as amended by the bill, is not limited to the gain realized on the disposition that is in the custody of the partnership, trustee, or executor. A partnership, trustee, or executor that does not have sufficient sales proceeds to satisfy its withholding liability (for example, because it mortgaged the disposed-of property on or after acquiring it, or agreed to accept payment for the disposed-of property on an installment basis) may request a qualifying statement from the Internal Revenue Service authorizing it to withhold a lesser amount.

Computing the tax to be withheld as a percentage of gain should, however, result (in many cases) in the collection of an amount of tax that more closely approximates the final tax liability of foreign partners, beneficiaries, and substantial owners than would the amount of tax collected were the tax computed as a percentage of the full amount realized. Withholding on the basis of gain is feasible under this special withholding rule because, unlike the buyer in the usual withholding situation (who may not know the seller's basis), the withholding agent here—a partnership, trustee, or executor—knows what the foreign taxpayer's gain from the disposition will be: the partnership, trustee, or executor itself computes the amount of that gain. The 28-percent withholding rate reflects the maximum 28-percent capital gains rate for corporations—the highest rate at which a foreign partner, beneficiary, or substantial owner could be taxed on its share of the gain from the disposition of a U.S. real property interest by a partnership, trust, or estate.

The bill clarifies the Secretary's authority to promulgate such regulations as are necessary to provide for withholding with respect to U.S. real property gains realized by foreign persons

through tiers of domestic partnerships or trusts. The bill also clarifies the Secretary's authority to impose withholding in an administratively workable manner in cases where interests in publicly traded U.S. entities are held by foreign persons through nominees. In such cases, it would be appropriate to require a nominee to withhold from distributions made through that nominee to a foreign interest holder.

These modifications will be effective for dispositions of U.S. real property interests that occur after the day 30 days after the bill's date of enactment.

Distributions by domestic U.S. RPHC's

The bill clarifies that no withholding is required on certain liquidations and redemptions that are not taxed under the substantive FIRPTA rules. It provides that the special rule requiring withholding by domestic U.S. RPHCs (and former domestic U.S. RPHCs) upon the distribution of property in a corporate liquidation or redemption will not apply when interests in the corporation are not U.S. real property interests by reason of Code section 897(c)(1)(B) on the date of the distribution.

As indicated above, section 897(c)(1)(B) excludes from the definition of a U.S. real property interest an interest in a corporation that (1) is not holding U.S. real property interests at the time the corporate interest is disposed of and (2) disposed of all U.S. real property interests it held during the section 897(c)(1)(A)(ii) base period in transactions in which the full amount of gain (if any) was recognized. If section 897(c)(1)(B) applies to a corporation's stock, a stock interest surrendered in connection with a liquidation or redemption by the corporation is not a U.S. real property interest. Therefore, the surrender of that stock interest is not a taxable disposition under the FIRPTA rules, and withholding on the surrender is inappropriate.

Taxable distributions by partnerships, trustees, and executors

The bill clarifies that a distribution to a foreign person of a U.S. real property interest by a domestic or foreign partnership, trustee, or executor is subject to withholding if such distribution is taxable under any of the substantive FIRPTA rules, not Code section 897(g) only.

Return-filing and remittance of tax

The bill clarifies that persons required to withhold tax under the FIRPTA withholding rules, like persons having substantive FIRPTA tax liability, are to pay the tax to and file the necessary returns with the United States in the case of real property interests located in the United States, and are to pay the tax to and file the necessary returns with the Virgin Islands in the case of real property interests located in the Virgin Islands.

Information returns—penalty provision

The bill amends the provision (Code sec. 6652(g)) imposing penalties on persons that fail to file required FIRPTA information returns to conform it with the revised information reporting rules of the Act.

g. Transfers of property to foreign persons pursuant to corporate reorganizations, etc. (sec. 1810(g) of the bill and sec. 367 of the Code)

Present Law

The Act added a rule (Code sec. 367(e)) requiring that a domestic corporation recognize gain on a liquidating distribution of appreciated property to any foreign person, under rules similar to those applicable to transfers to foreign corporations. The rules applicable to transfers to foreign corporations were generally restructured under the Act. The transactions with respect to which Congress intended to require the recognition of gain by a U.S. transferor included certain distributions to foreign persons pursuant to Code section 355 (relating to distributions of stock and securities of controlled corporations). However, because the applicability of section 355 does not depend on whether the distributee is a corporation, section 367(a)(1) does not reach this result. Section 355 transfers are appropriately addressed under section 367(e), which does not look to the corporate status of the transferee, rather than section 367(a), which applies only to transfers to foreign corporations.

Explanation of Provision

The bill provides that transfers of stock by domestic corporations to foreign persons pursuant to Code section 355 (or so much of section 356 as relates to section 355) will give rise to the recognition of gain under Code section 367(e), to the extent provided in regulations. The committee expects that the Secretary will carefully consider the extent to which it is appropriate, in view of the purpose of section 367(e), to require the recognition of gain upon the transfer of the stock of a domestic corporation to foreign persons under section 355.

h. Foreign personal holding companies

U.S. shareholders in a foreign personal holding company are subject to current U.S. tax on their pro rata share of the company's undistributed foreign personal holding company income. The foreign personal holding company rules were enacted (in 1937) to prevent U.S. taxpayers from accumulating income tax-free in foreign "incorporated pocketbooks."

(1) Same country dividend and interest exception (sec. 1810(h)(1) of the Act and sec. 552 of the Code)

Present Law

The Act provides that dividends and interest received by a foreign corporation from a person (1) related to the recipient, (2) organized in the same country as the recipient corporation, and (3) having a substantial part of its assets used in its trade or business located in that same country generally do not count in determining whether the foreign corporation is a foreign personal holding company. The Act does not define related person for this purpose.

Explanation of Provision

For the purpose of the Act's rule excluding same country dividends and interest from the foreign personal holding company calculation, the bill adopts the related party definition of the controlled foreign corporation rules (sec. 954(d)(3)). The bill provides that a person is a related person with respect to a foreign personal holding company if the person is (1) an individual, partnership, trust, or estate which controls the foreign personal holding company, (2) a corporation which controls, or is controlled by, the foreign personal holding company, or (3) a corporation which is controlled by the same person or persons which control the foreign personal holding company. For this purpose, control means the ownership, directly or indirectly, of stock possessing more than 50 percent of the total combined voting power of all classes of stock entitled to vote. The bill incorporates certain rules for determining ownership of stock for this purpose.

(2) Interposed foreign entities (sec. 1810(h)(2) of the Act and sec. 551(f) of the Code)

Present Law

The Act added a tracing rule to the foreign personal holding company rules that was intended to make clear that U.S. taxpayers cannot interpose foreign entities (other than other foreign personal holding companies) between themselves and a foreign personal holding company to avoid the foreign personal holding company rules. Under the tracing rule, stock of a foreign personal holding company that is owned by a foreign entity other than another foreign personal holding company is to be considered (for income inclusion purposes) as being owned proportionately by the foreign entity's partners, beneficiaries, or stockholders.

Explanation of Provision

The bill clarifies that the tracing rule applies to all foreign trusts and estates interposed between U.S. taxpayers and foreign personal holding companies.

i. Treatment of certain indirect transfers (sec. 1810(i) of the bill and sec. 1248(i) of the Code)

Present Law

Code section 1248(a) requires gain realized by certain U.S. persons on the disposition of stock in a foreign corporation to be treated as ordinary income to the extent of allocable earnings and profits of the foreign corporation. Under the Act, if shareholders of a U.S. corporation exchange stock in the corporation for newly issued stock (or treasury stock) of a foreign corporation ten percent or more of the voting stock of which is owned by the U.S. corporation, the transaction is recast for purposes of applying section 1248. Because the Act provides that the U.S. corporation is treated as having distributed the stock in the foreign corporation "in redemption" of the shareholder's stock, every indirect transfer could be viewed as a nonliquidating distribution.

The Act also clarified the treatment of subsequent distributions of earnings that resulted in the recharacterization of gain under section 1248. Taxpayers were given an election to apply this provision retroactively to transactions occurring after October 9, 1975.

Section 1248(g) provides exceptions to section 1248(a) for cases in which gain is taxable as ordinary income under other provisions of the Code. Section 1248(g)(2) refers to any gain on exchanges to which section 356 applies. Under section 356, gain is recognized to the extent of nonqualifying consideration received in a reorganization. Section 356 provides that gain is taxable as a dividend if the exchange has the effect of a dividend, but only to the extent of a shareholder's ratable share of accumulated earnings and profits. If the amount of gain exceeds the allocable portion of earnings and profits, the excess is generally taxed as capital gain.

Explanation of Provision

The bill clarifies that an indirect transfer is recast as a distribution in redemption or liquidation, whichever is appropriate. For example, assume that a U.S. corporation ("P") is the sole shareholder of a U.S. holding company ("Holdco"). Holdco owns 100 percent of the stock of a corporation that was organized under the laws of a foreign country ("S"). Holdco merges downstream into S; in the merger P exchanges Holdco stock for stock of S. Under section 1248(i), the transaction is treated as if Holdco distributed the S stock in a liquidating distribution to P. This result occurs because Holdco goes out of existence and the transaction has the economic effect of a liquidation. Under section 1248(f)(2), however, no amount is includible in Holdco's gross income under section 1248(f)(1), because the S stock is distributed to a domestic corporation, P, which is treated as holding the S stock for the period the stock was held by Holdco and which satisfies the prescribed stock ownership requirements with respect to S. Also, no amount is includible in P's gross income under section 332.

The bill extends the period during which the election relating to previously taxed earnings can be made until one year after enactment of the Technical Corrections Act.

The bill also amends section 1248(g)(2) to limit the exception to a shareholder's gain that is characterized as dividend income under section 356.

j. Stapled stock

(1) Collection of tax (sec. 1810(j)(1) of the bill and sec. 269B(b) of the Code)

Present Law

The Act treats a foreign corporation whose stock is stapled to that of a U.S. corporation as a U.S. corporation. That corporation is thus taxable on its worldwide income. It is not clear, in some cases, how the United States would collect the tax due under this rule. The Act requires the Secretary of the Treasury to prescribe such regulations as may be necessary to prevent tax avoidance or evasion through the use of stapled entities.

Explanation of Provision

The bill specifies that the regulations that the Secretary is to prescribe pertaining to stapled entities may include regulations providing that any tax imposed on a foreign corporation that the Act treats as a U.S. corporation may, if that corporation does not pay them, be collected from the U.S. corporation to which it is stapled or from the shareholders of the foreign corporation. For example, assume that all the interests in a foreign corporation are stapled to interests in a U.S. corporation. In that case, regulations may provide that the U.S. corporation is liable for any tax that the foreign corporation does not pay. Alternatively, it could be appropriate to collect the tax from the shareholders of the stapled foreign corporation.

(2) Foreign-owned corporations (sec. 1810(j)(2) of the bill and sec. 269B(b) of the Code)

Present Law

Under the stapled entity rules of the Act, a foreign corporation whose stock is stapled to that of a U.S. corporation is treated as a U.S. corporation, whoever owns the two corporations. However, the purpose of the stapled entity rules was, in general, to prevent avoidance of tax rules that apply to U.S.-controlled foreign corporations.

Explanation of Provision

The bill limits the stapled entity rules treating a foreign corporation as domestic. These rules will not apply if it is established to the satisfaction of the Secretary of the Treasury that both the stapled foreign corporation and the U.S. corporation to which it is stapled are foreign owned. A corporation is foreign owned for this purpose if less than half of its stock, by vote or value, belongs directly or indirectly to U.S. persons.

k. Insurance of related parties by a controlled foreign corporation (sec. 1810(k) of the bill and sec. 954(e) of the Code)

Present Law

U.S. shareholders of controlled foreign corporations are currently taxable on the foreign base company services income of those corporations. Foreign base company services income is income derived in connection with certain services that satisfy a two-pronged test: (1) they are performed for or on behalf of any person related to the controlled foreign corporation and (2) they are performed outside the country under the laws of which the controlled foreign corporation is organized. For the purpose of the first prong of this test, a related person is generally one with more than 50 percent common ownership. The Act amended the second prong of the test in the case of insurance services: if the primary insured is a related person (defined more broadly in this case to include a 10-percent U.S. shareholder and persons related to that shareholder), any services performed with respect to any policy of insurance or reinsurance will be treated as having been performed in the country in

which the risk of loss against which that related person is insured is located. The Act did not amend the definition of related person with respect to the first prong of the test.

Explanation of Provision

The bill makes it clear that there is a single definition of related person for the purpose of determining the amount of foreign base company services income that arises from insurance. In applying the rule that treats income from services performed with respect to insurance or reinsurance for or on behalf of related persons as foreign base company services income (the first prong of the base company services income test), the primary insured will be treated as a related person if it is related within the broad related party rule used specifically for insurance services under the Act—the rule that reaches 10-percent U.S. shareholders and persons related to them.

l. Definition of resident alien (sec. 1810(l) of the bill and sec. 7701(b)(4)(E) of the Code)

Present Law

Resident aliens, like U.S. citizens, are subject to U.S. tax on their worldwide income at the regular graduated rates. The Act provided standards for determining whether a foreign individual is a resident alien for income tax purposes.

Under these standards, an individual is considered a U.S. resident if the individual has entered the United States as a lawful permanent U.S. resident ("green card test"). In addition, an individual who spends substantial time in the United States in any year or over a three-year period is generally a U.S. resident (the "substantial presence test"). Days spent in the United States as an "exempt individual," a term that includes certain teachers, trainees, and students temporarily present in the United States under subparagraphs (F) and (J) of section 101(15) of the Immigration and Nationality Act, do not count as days of U.S. presence under the substantial presence test. However, a teacher or trainee cannot be an exempt individual in a particular calendar year if the teacher or trainee was exempt as a teacher, trainee, or student for any part of two of the six preceding calendar years. Thus, foreign teachers and trainees may work as such in the United States during no more than two calendar years in any seven calendar-year period without exposing themselves to possible resident alien treatment under the substantial presence test.

In 1961, to relieve foreign students, teachers, and scholars of U.S. tax liability that had the effect of reducing the value of their stipends while they were in the United States, Congress provided that compensation paid by a foreign employer to a nonresident alien individual for the period the individual is temporarily present in the United States as a non-immigrant (under subparagraph (F) or (J) of section 101(15) of the Immigration and Nationality Act) is not subject to U.S. tax (Code sec. 872(b)(3), added by the Mutual Educational and Cultural Exchange Act of 1961). Because foreign teachers and trainees who work as such in the United States during more

than two calendar years may become resident aliens under the substantial presence test, some foreign teachers and trainees admitted to the United States under exchange visitor programs during three or four calendar years whose foreign income would otherwise be exempt from U.S. tax under Code section 872(b)(3) will be subject to U.S. tax on such income received or accrued during their third and fourth calendar years in the United States.

Under the Act, alien individuals who move to the United States too late in a calendar year to satisfy the substantial presence test for that calendar year are not treated as U.S. residents for any portion of that calendar year (unless they satisfy the green card test for some portion of such year), even if they satisfy the substantial presence test in the following calendar year. Tax benefits accorded to U.S. residents—for example, personal exemptions, joint filing eligibility, and ability to claim itemized deductions—are, therefore, not available to such aliens for any portion of the calendar year in which they moved to the United States.

Explanation of Provision

The bill increases the exemption period for teachers and trainees, all of whose compensation would otherwise be exempt from tax under the Mutual Educational and Cultural Exchange Act, to a maximum of four calendar years. Under the bill, days spent working in the United States as a teacher or trainee during four calendar years in any seven calendar year period do not count as days of U.S. presence for purposes of the substantial presence test if all of the individual's compensation is described in Code section 872(b)(3).

Under the bill, a qualifying alien individual may elect to be treated as a U.S. resident in a calendar year (the "election year") in which the individual is not otherwise treated as a U.S. resident, if the individual meets the substance presence test for the following calendar year. A qualifying alien individual is one who (1) was not a U.S. resident in the year preceding the election year; (2) is present in the United States for at least 31 consecutive days in the election year; and (3) is present in the United States during the period beginning with the first day of the 31-day presence just referred to and ending with the last day of the election year for a number of days equal to or exceeding 75 percent of the number of days in such period. In applying this 75-percent test, an individual will be treated as present in the United States for up to 5 days during which he or she was actually absent from the country.

A qualifying alien individual who makes the new election will be treated as a U.S. resident only for that portion of the election year which begins on the first day of the earliest presence period for which the individual can satisfy both the 31-day and 75-percent tests described above.

For purposes of both the 75-percent and 31-day tests, an individual will not be treated as present in the United States on any day if the individual is an exempt individual for that day (as determined for purposes of the substantial presence test).

A qualifying alien individual must make the election on his or her tax return for the election year. However, the election may not be made before the individual has met the substantial presence test

for the calendar year following the election year. Once an election is made, it remains in effect for the election year unless revoked with consent of the IRS.

The operation of the new election provision is illustrated in the following example: An alien individual vacations in the United States from January 1 through January 31, 1986. He returns to the United States on October 15, 1986, and begins working on a permanent basis for a U.S. company on that day. For the remainder of 1986, he is absent from the country for 10 days only, from December 20 through December 29. He satisfies the substantial presence test in 1987. He was not a U.S. resident in 1985.

The individual may elect to be treated as a U.S. resident for 1986 under the new provision. His residency starting date is October 15, 1986, because that is the first day of the earliest period in 1986 for which both the 31-day and 75-percent tests are satisfied. (The 75-percent test is not satisfied with respect to the presence period commencing on January 1, 1986).

11. Compliance Provisions (sec. 1811 of the bill and secs. 6031, 6050H, 6050K, 6660, and 7502 of the Code)

Present Law

The Act contained compliance provisions requiring that:

(1) Recipients of mortgage interest report to the payor and the Internal Revenue Service the amount of mortgage interest received;

(2) Information reporting to the Internal Revenue Service and the taxpayers involved be completed on exchanges of certain partnership interests;

(3) Brokers furnish statements of substitute dividend or tax-exempt interest payments;

(4) A penalty be imposed for substantial underpayments of estate or gift taxes attributable to valuation understatements;

(5) All deposits of $20,000 or more of any tax required to be deposited under the provisions of section 6302(c) of the Code that are made by any taxpayer required to deposit any tax under that section more than once a month must be made by the due date of the deposit, regardless of the method of delivery; and

(6) Partnerships must report to the IRS and provide a copy to the partner of each partner's share of specific items of income, deductions, and other necessary information so that the partner can complete his or her tax return.

Explanation of Provision

The bill makes the following changes to these compliance provisions:

(1) The bill provides that a cooperative housing corporation must report to both its tenant-stockholder and the Internal Revenue Service on the tenant-stockholder's proportionate share of interest paid to the cooperative housing corporation. The bill also corrects a citation to the Code in the effective date of a related penalty provision.

(2) The bill corrects an internal reference in the provision relating to reporting on exchanges of certain partnership interests.

(3) The bill makes a conforming amendment to section 6678 (relating to penalties for failing to file statements) to include failures to report the substitute payments. The bill also clarifies that the penalty for intentional disregard of the requirement to report these substitute payments to the IRS is 10 percent of the aggregate amount required to be reported.

(4) The bill provides a cross-reference to the definition of underpayment for purposes of the penalty for valuation understatements with respect to estate or gift taxes.

(5) The bill clarifies that the new deposit rules apply to any taxpayer required, under the provisions of section 6302(c), to deposit any tax under that provision more than once a month.

(6) The bill improves information reporting by partnerships where a partner's interest is held by a nominee.

12. Miscellaneous Reform Provisions

a. Tax benefit rule (sec. 1812(a) of the bill and sec. 1511 of the Code)

Present Law

The Act amended the rules of prior law to more clearly reflect economic reality in applying the statutory tax benefit exclusion. To accomplish this, the Act repealed the prior law "recovery exclusion" concept and provided that an amount is excludible from income only to the extent it did not reduce income subject to tax.

Explanation of Provision

The bill provides that an amount is excludible from income only to the extent that it does not reduce a taxpayer's income tax under chapter 1 of the Code. Thus, where a deduction reduces taxable income but does not reduce tax (because, for example, the taxpayer is subject to the alternative minimum tax), recovery of the amount giving rise to the deduction may be excludible from income under section 111. This amendment is not intended to change the result in the example set forth in the committee reports accompanying the Act.

b. Low interest loans (sec. 1812(b) of the bill and sec. 7872 of the Code)

Present Law

Section 7872 generally provides that certain loans bearing a below-market rate of interest are treated as loans bearing a market rate of interest accompanied by a payment or payments from the lender to the borrower which are characterized in accordance with the substance of the particular transaction, e.g., gift, compensation, dividend, etc.

For purposes of determining the appropriate market rate of interest as well as the timing of the deemed transfers, section 7872 distinguishes between demand loans and term loans. As presently

provided by section 7872, a demand loan is defined as a loan which is due on demand. A term loan is defined as a loan which is not a demand loan. Section 7872(f)(5) provides that the term demand loan includes (for purposes other than determining the applicable Federal rate) a loan which is not transferable and the benefits of the interest arrangement of which is conditioned on the future performance of substantial services by an individual.

For income tax purposes, in the case of a below-market term loan that is not a gift loan, section 7872 treats the excess of the amount loaned over the present value of all payments due under the loan as having been transferred from the lender to the borrower at the time the loan is made. In the case of a below-market demand loan as well as all gift loans, the deemed transfer occurs at the end of each taxable year and the amount of the deemed transfer is the foregone interest that year.

In applying the prescribed market rate, section 7872 requires semi-annual compounding for non-gift term loans, but does not require semi-annual compounding for gift loans and demand loans.

Section 7872 also provides that withholding by an employer is not required where a deemed payment arising from a below-market demand loan is in the nature of compensation. However, there is no similar exception from withholding where a deemed compensation payment arises from a below-market term loan.

Under section 7872, a loan to Israel at a below-market rate might be characterized as a loan bearing a market rate of interest accompanied by a non-deductible gift to Israel.

Under section 4941 of the Code, certain so-called acts of self-dealing between a private foundation and a "disqualified person" are subject to penalty excise taxes on the amount involved. Generally, a loan between the foundation and a disqualified person is an act of self-dealing. However, an exception is provided for interest-free loans to the private foundation, provided that the proceeds of the loan are used exclusively for certain designated charitable purposes.

Explanation of Provision

The definitions of term loan and demand loan in section 7872 appear to treat loans with an indefinite maturity as term loans. However, it often is impractical to treat a loan with an indefinite maturity as a term loan, since section 7872 requires the computation of the present value of the payments due under such a loan. Accordingly, the bill grants the Treasury Department authority to treat loans with indefinite maturities as demand loans rather than term loans.

The bill modifies the special provision of section 7872 that treats certain term loans as demand loans for the purpose of determining the timing of deemed interest and compensation payments. Under the bill, a loan would be entitled to such treatment if the benefit of the interest arrangement of the loan is not transferable and is contingent upon the performance of substantial future services by an individual. Thus, if a loan satisfies these conditions, it would receive the special treatment even if the lender or the borrower (or either) could transfer the loan.

The various time value of money provisions of the Code, (including provisions relating to the treatment of below-market term loans), generally require the use of semi-annual compounding in calculating interest. In order to treat all loans consistently, the bill provides that semi-annual compounding will also be required in calculating interest with respect to gift loans and demand loans under section 7872.

The Conference Report to the Act indicated that payments of compensation, deemed to have been made by section 7872, would be subject to the information reporting requirements but not the withholding requirements of the Code. H.R. Rep. No. 98-861, 98th Cong., 2d Sess. 1017 (1984). The failure to except from the withholding requirements deemed payments of compensation arising from below-market term loans was inadvertent, and the bill corrects this omission.

The bill also provides an exception from section 7872 for loans to Israel.

Finally, the bill clarifies that Congress did not intend in enacting section 7872 to affect the definition of acts of self-dealing with private foundations.

c. Transactions with related persons (sec. 1812(c) of the bill and sec. 267 of the Code)

Present Law

The Act generally imposes a matching principle by placing taxpayers on the cash method of accounting with respect to the deduction of amounts owed to a related cash-basis taxpayer. In other words, the deduction by the payor is generally allowed no earlier than when the related payee recognizes the corresponding income.

The application of the above described rule is unclear when the related payee is a related foreign person that does not, for many Code purposes, include in gross income foreign source income that is not effectively connected with a U.S. trade or business.

In addition, the Act also generally deferred losses on sales of property between corporations which are members of the same controlled group of corporations. An exception was provided for certain sales of inventory to or from foreign corporations.

Explanation of Provision

The bill directs the Secretary of the Treasury to issue regulations applying the matching principle generally applicable to related party transactions in cases in which the person to whom the payment is to be made is not a United States person. For example, assume that a foreign corporation, not engaged in a U.S. trade or business, performs services outside the United States for use by its wholly owned U.S. subsidiary in the United States. That income is foreign source income that is not effectively connected with a U.S. trade or business. It is not subject to U.S. tax (or, generally, includible in the foreign parent's gross income). Under the bill, regulations could require the U.S. subsidiary to use the cash method of accounting with respect to the deduction of amounts owed to its foreign parent for these services. In the case of amounts accrued to

a controlled foreign corporation by a related person, regulations might appropriately require the payor's accounting method to conform to the method that the controlled foreign corporation uses for U.S. tax purposes.

Regulations will not be necessary when an amount paid to a related foreign person is effectively connected with a U.S. trade or business (unless a treaty reduces the tax). In that case, present law already imposes matching. However, regulations may be necessary when a foreign corporation uses a method of accounting for some U.S. tax purposes (e.g., because some of its income is effectively connected), but when the method does not apply to the amount that the U.S. person seeks to accrue.

The bill also provides that the special exception from section 267 for sales of inventory to or from foreign corporations applies where the party related to the foreign corporation is a partnership.

For transfers after May 6, 1986, the bill provides that the provisions of section 707(b)(1)(A) and 707(b)(2)(A) will apply whether or not the person constructively holding a 50-percent partnership interest was himself a partner. In addition, the bill provides that the deferral provisions of section 267(a)(2) will apply to two partnerships in which the same persons hold a more than 50-percent of the capital interests or profits interests. This rule is intended to replace the rule in the Treasury regulations,[7] which was suggested by the 1984 Committee Reports, relating to transactions between related partnerships with common partners.

d. Federal Home Loan Mortgage Corporation ("Freddie Mac") (sec. 1812(d) of the bill and sec. 246 of the Code)

Present Law

General background

The Act repealed the prior law exemption from Federal income tax of Freddie Mac, effective January 1, 1985. Various transition rules were included to ensure that, to the extent possible, Freddie Mac was subject to tax only on its post-1984 income.

The 12 regional Federal Home Loan Banks, which hold the common stock of Freddie Mac, are themselves exempt from tax; however, the member institutions of the Home Loan Banks are subject to tax.

In a transaction completed in early 1985, Freddie Mac issued a new class of preferred stock in itself to the regional Federal Home Loan Banks, which then transferred the stock to their member institutions. Distributions with respect to this preferred stock will thus be paid directly to the member institutions. The common stock of Freddie Mac continues to be owned by the Federal Home Loan Banks.

Dividends received deduction

The Act allows shareholders of the Federal Home Loan Banks a dividend received deduction for that portion of dividends received from a Federal Home Loan Bank which is allocable to dividends

[7] Temp. Reg. Sec. 1.267(a)-2T(c), Questions 2 and 3.

paid to the Federal Home Loan Bank by Freddie Mac out of Freddie Mac earnings and profits for periods after December 31, 1984. Special "stacking" rules are included in order that a deduction may be received only with respect to dividends which are properly allocable to post-1984 earnings and profits of Freddie Mac. No dividends received deduction is allowed to member institutions for dividends received from Federal Home Loan Banks which are allocable to Freddie Mac earnings and profits which Freddie Mac accumulated before January 1, 1985 (i.e., prior to the date of taxability).

In addition to these rules, the Act states that, for all income tax purposes, Freddie Mac is to be treated as having no accumulated earnings and profits as of January 1, 1985. This provision was intended to ensure that the deduction for dividends received by member institutions from the Federal Home Loan Banks would apply only to the extent the dividends are allocable to post-1984 earnings and profits of Freddie Mac (i.e., to Freddie Mac income which has already been subject to tax).

Explanation of Provisions

Dividends received deduction

The bill makes several adjustments in the dividends received deduction for dividends allocable to post-1984 Freddie Mac income.

First, the bill adds an explicit statutory rule stating that no dividends received deduction is to be allowed with respect to dividends paid by Freddie Mac out of earnings and profits accumulated before January 1, 1985 (i.e., the date of taxability). This rule is in addition to the present law rule which denies a dividends received deduction for dividends paid by a Home Loan Bank which are ultimately allocable to pre-1985 Freddie Mac income. Thus, under the bill, dividends received deductions would be limited to amounts allocable to post-1984 (i.e., taxable) Freddie Mac income, both in the case of income distributed via the Federal Home Loan Banks and in the case of any dividends which may be paid directly to Freddie Mac corporate shareholders who are themselves subject to tax (e.g., member institutions which hold Freddie Mac preferred stock). This rule allows a dividends received deduction where necessary to avoid a double corporate-level tax on Freddie Mac income. In conjunction with this amendment, the present law rule under which Freddie Mac is treated as having no accumulated profits as of January 1, 1985, is repealed.

Second, in the case of income distributed via a Federal Home Loan Bank, the bill clarifies that no dividends paid by Freddie Mac may serve as the basis for more than one deduction for dividends received from a Federal Home Loan Bank. This clarification applies both to dividends paid by a Federal Home Loan Bank in different years, or when two or more dividends are paid during the same year.

Third, in the case of dividends paid directly by Freddie Mac to taxable corporate shareholders, the bill permits a deduction for dividends received in 1985, as well as later years. This result would otherwise be prevented by a Code provision which denies dividends received deductions for one year after the corporation paying the dividend ceases to be tax-exempt (sec. 246(a)(1)).

Tax treatment of preferred stock distribution

The bill provides that, for all purposes under the Code, the distribution of preferred stock by Freddie Mac to the Federal Home Loan Banks in late 1984, and the distribution of such stock by the Federal Home Loan Banks to their member institutions in January, 1985, are to be treated as if they were distributions of money in an amount equal to the fair market value of the stock on the date of the distribution by the Federal Home Loan Banks, followed by the payment of such money by the member institutions to Freddie Mac in return for its stock. Thus, under the special rule, the Federal Home Loan Banks will be treated as receiving cash dividends to the extent that the money deemed received from Freddie Mac is attributable to earnings and profits of Freddie Mac, and the earnings and profits of the Federal Home Loan Banks will be increased by an equivalent amount. The member institutions, in turn, will be treated as receiving cash dividends from the Federal Home Loan Banks, to the extent that the money deemed received from the Federal Home Loan Banks is attributable to earnings and profits of the Federal Home Loan Banks (taking into account the earnings and profits resulting from the distribution from Freddie Mac). Because these dividends are allocable to pre-1985 earnings and profits of Freddie Mac, the member institutions will not be entitled to a dividend received deduction with respect to these amounts.

Under the special rule above, the earnings and profits of Freddie Mac will be reduced by the amount deemed distributed to the Federal Home Loan Banks. If Freddie Mac later makes distributions to the member institutions out of its pre-1985 income, these distributions will be treated as dividends (and will not qualify for a dividends received deduction) to the extent (if any) that pre-1985 earnings and profits of Freddie Mac exceeded the amount deemed distributed at the time of the preferred stock distribution.

e. Personal use property (sec. 1812(e) of the bill and secs. 280F and 4064 of the Code)

Present Law

The Act provided limitations on the maximum amount of investment tax credit and depreciation that a taxpayer may claim with respect to a passenger automobile. The Act also provided that if use in a trade or business of listed property does not exceed 50 percent, no investment tax credit is available, and depreciation must be determined on the straight line method over the earnings and profits life of the property. Listed property is any passenger automobile or other means of transportation, any entertainment, recreation, or amusement property, any computer, or any other property specified in regulations. However, any computer used exclusively at a regular business establishment is not considered to be listed property. Employee use of listed property must be for the convenience of the employer and a condition of employment for the employee to be able to claim a deduction or credit for the use of listed property.

Explanation of Provision

The bill clarifies the definition of passenger automobile by providing that the weight of the automobile shall not include the weight of the passengers or the weight of any cargo. Present law will continue to apply to trucks and vans.

The bill also clarifies that the requirements that, in order to take a deduction or credit, employee use of listed property be for the convenience of the employer and required as a condition of employment also apply to the amount of any deduction allowable to the employee for rentals or other payments under a lease of listed property.

The bill also clarifies that computers eligible for the exception from the definition of listed property must be owned or leased by the person operating the business establishment, in addition to being used exclusively at a regular business establishment. See H. Rep. No. 98-861 (June 23, 1984), p. 1026 (Conference Report).

Finally, the bill provides that, except to the extent provided in regulations, listed property used as a means of transportation (within the meaning of section 280F(d)(4)(A)(ii)) does not include property substantially all the use of which is in the business of providing unrelated persons services consisting of the transportation of persons or property for hire.

B. Technical Corrections to Life Insurance Provisions

1. Certain amounts not less than surrender value of contract (sec. 1821(a) of the bill and sec. 807(c) of the Code)

Present Law

Present law provides that net increases or decreases in reserves and similar items should be taken into account in computing life insurance company taxable income (LICTI). For purposes of computing increases or decreases in life insurance reserves, the amount of the reserve for any contract is the greater of the net surrender value of such contract or a Federally prescribed reserve; the Federally prescribed reserve requires a company to use a particular method for determining the amount of the reserve, the prevailing State assumed interest rate, and the prevailing commissioner's standard mortality or morbidity table.

Among the items for which increases or decreases are taken into account in computing LICTI are amounts (discounted at the appropriate rate of interest) necessary to satisfy the obligations under insurance and annuity contracts, but only if such obligations do not involve, at the time with respect to which the computation is made, life, accident, or health contingencies. For these purposes, the appropriate rate of interest for any obligation is the higher of the prevailing State assumed interest rate as of the time such obligation first did not involve life, accident, or health contingencies or the rate of interest assumed by the company (as of such time) in determining the guaranteed benefit. Present law does not provide that, in computing increases or decreases in amounts discounted at the appropriate rate of interest, the taxpayer can take into account

the net surrender value of the contract if such value is higher than the amount discounted at the appropriate rate.

With respect to determining what method should be used in computing the Federally prescribed reserves for life insurance contracts, the 1984 Act adopted the provision as it was passed by the Senate. In explaining this, the Statement of Managers for the Conference Report expanded the explanation previously made in the Senate report with respect to how annuity reserves should be revalued as of January 1, 1984. In general, the Federally prescribed reserve methods refer to those recommended by the NAIC for the particular type of contract. Thus, in computing any life insurance reserve (including an annuity reserve), a company must take into account any factors specifically recommended by the NAIC. If specific factors are not recommended by the NAIC prescribed reserve method, the prevailing State interpretation of such method should be considered for purposes of determining what factors can be taken into account in applying the computation method for tax purposes. Because there were divergent State views on how the Commissioners' Annuities Reserve Valuation Method (CARVM, the reserve method prescribed for annuity contracts) should be interpreted, and there was a possibility that the NAIC would act to resolve State differences by the end of 1984, the Statement of Managers indicated that if the NAIC acted in 1984, their recommendations would be given retroactive effect.

The NAIC did not act to resolve the State differences on how CARVM should be applied. Accordingly, annuity reserves should have been revalued as of January 1, 1984, in accordance with the prevailing State interpretation of CARVM. It is understood that, through 1983, the prevailing State interpretation of CARVM was that annuity reserves could be reduced by the amount of any surrender charges (whether or not such charges were contingent). Thus, it was assumed that, failing action by the NAIC in 1984, annuity reserves would be revalued and computed for tax purposes by taking into account any surrender charges.

Explanation of Provision

The bill provides that, in computing the increases or decreases of amounts discounted at interest under insurance and annuity contracts, the amount taken into account will in no case be less than the net surrender value of such contract. This provision recognizes that amounts under these contracts discounted at the prevailing State assumed interest rate may in fact yield a reserve item which is less than the net surrender value guaranteed by the contract. The bill allows the taxpayer to recognize at least its current liability with respect to obligations not involving life, accident, or health contingencies, as represented by the guaranteed net surrender value of a contract. As is the case with life insurance reserves, however, the amounts taken into account cannot exceed the amounts that would be taken into account with respect to such contract as of such time in determining statutory reserves (as defined in sec. 809(b)(4)(B)).

In addition, the bill provides that, when the Secretary by regulation changes the table applicable to a type of contract, the new

table shall be treated as if it were a new prevailing commissioner's standard table adopted by the 26th State as of a date (no earlier than the date the regulation is issued) specified by the Secretary.

2. Clarification of definition of excess interest (sec. 1821(b) of the bill and sec. 808(d)(1) of Code)

Present Law

Under present law, excess interest is defined as any amount in the nature of interest paid or credited to a policyholder in his capacity as such, and determined at a rate in excess of the prevailing State assumed interest rate for such contract.

Explanation of Provision

The bill changes the definition of excess interest to mean any amount in the nature of interest in excess of the prevailing State assumed rate for such contract. This change is intended to clarify that the term excess interest refers only to the excess amount and not to the entire amount in the nature of interest (including the amount determined at the prevailing State assumed interest rate).

3. Coordination of 1984 fresh start adjustment with certain accelerations of policyholder dividends deductions (sec. 1821(c) of the bill and sec. 808 of the Code)

Present Law

As under prior law, present law allows a deduction for dividends or similar distributions to policyholders. Present law departs from prior law, however, in that the amount of the deduction for any taxable year is the amount of policyholder dividends paid or accrued during the taxable year rather than the amount of policyholder dividends paid during the taxable year plus the increases (or less the decreases) in the reserves for policyholder dividends that are payable during the year following the taxable year. Under a transitional rule, this change from a reserve to an accrual method was not treated as a change in a method of accounting. Thus, no income or loss was recognized with respect to amounts in existing policyholder dividend reserves, and taxpayers were given a "fresh start" in computing their policyholder dividends deduction.

Explanation of Provision

The "fresh start" was granted with respect to the accounting change for policyholder dividends on the assumption that insurance companies would continue to follow their general business practice in declaring policy dividends at the end of the calendar year to be payable on policy anniversaries during the following calendar year only in the event the policy remained outstanding on such anniversary. It was understood that, given the general business practices, the present-law change in policyholder dividends accounting had the effect of delaying the deduction for policyholder dividends to the taxable year in which they are paid.

It appears that by guaranteeing policy dividends on termination (which may not change necessarily the payment date of policy divi-

dends) or by changing the payment date by making policy dividends available upon declaration, a company can accelerate the deduction for approximately one half the policyholder dividends that would have been deducted in the following taxable year if there had been no change in the company's business practices in declaring policy dividends. As a practical matter, the amount of the acceleration of the policyholder dividend deduction could be viewed as restoring a company, in part, to the position it enjoyed under prior law with respect to the timing of the policyholder dividends deduction. The "fresh start" for the change in policyholder dividends accounting was intended to mitigate the detriment caused taxpayers by a statutory change in such accounting; to the extent the detriment caused by the statutory change is mitigated in fact by a company's own changed business practices, the "fresh start" was not intended to give a company additional tax benefits.

For these reasons, the bill adopts a provision that would reduce a company's policyholder dividends deduction by the amount by which the company's policyholder dividends deduction was accelerated because of a change in business practices. This reduction for an accelerated policyholder dividends deduction is made before any reduction for the ownership differential provision for mutual life insurance companies and does not exceed on a cumulative basis the amount of a company's 1984 fresh-start adjustment for policyholder dividends. Also, the determination of the amount of the accelerated policyholder dividends deduction and the amount of the 1984 fresh-start adjustment will be made separately with respect to each line of business.

The term "accelerated policyholder dividends deduction" means the amount that would be determined for the taxable year as policyholder dividends paid or accrued, but which would have been determined for a later taxable year under the business practices of the company as in effect at the close of the preceding taxable year. Thus, the types of changes in business practices that would result in an accelerated policyholder dividends deduction include guaranteeing of policy dividends on termination for a particular product line or changing the actual payment date of policy dividends (for example, by making such dividends available upon declaration). On the other hand, changes in plans of insurance being sold or the development of new products will not be treated as resulting in an accelerated policyholder dividends deduction. For example, the introduction and sale of a universal life insurance product that credits excess interest to the cash surrender value on a monthly basis and that may depart from prior business practices of selling traditional participating life insurance policies that pay policy dividends at the policy anniversary date is not the type of change in business practice covered by this provision.

In addition, policyholder dividends paid or accrued on policies issued after December 31, 1983, generally will not produce accelerated policyholder dividends. However, a policy issued after December 31, 1983, in exchange for a substantially similar policy issued before January 1, 1984, is treated as if the policy were issued on the date that the original policy were issued. For this purpose, whether policies are substantially similar is determined without regard to the time of accrual of policyholder dividends. Under this

rule, an accelerated policyholder dividends deduction will result if a life insurance company exchanges an old policy for a new policy with substantially similar terms, except that the new policy guarantees policy dividends or makes such dividends available upon declaration.

Under the bill, certain policy exchanges are not treated as exchanges for substantially similar policies. This provision, which exempts policies from the accelerated policyholder dividend provision, applies if the policy is a group policy purchased by an employer under a plan to provide welfare benefits (within the meaning of sec. 419(e)(2)). Similarly, if a company alters the terms of a policy so that the policy does not constitute a welfare benefit fund, such an alteration is not treated as a change in business practice.

The bill specifically provides that this provision does not apply to a mere change in the amount of policyholder dividends. Thus, if a company changes its dividends scale, for example, by increasing the amount of the policyholder dividend over the previous year or by changing the formula for determining the amount of policy dividends to include items not previously considered in determining the amount of policyholder dividends (e.g., capital gains), this provision would not apply to treat such change as an acceleration of policyholder dividends pursuant to a change in business practices.

The cumulative amount of the reduction of a company's policyholder dividends deduction with respect to a particular line of business under this provision is limited to the 1984 fresh-start adjustment for policyholder dividends with respect to such business. Specifically, the 1984 fresh-start adjustment for policyholder dividends means the amounts held as of December 31, 1983, by the company as reserves for policyholder dividends that were deductible in 1983, less dividends that accrued before January 1, 1984. Also, the adjustment amount will be properly reduced to reflect the amounts of previously nondeductible policyholder dividends as determined under prior-law section 809(f).

4. Clarification of equity base (sec. 1821(d) of the bill and sec. 809(b) of the Code)

Present Law

Although the general rules and definitions relating to policyholder dividends apply to stock and mutual life insurance companies alike, the amount of the deduction for policyholder dividends for mutual companies is reduced by an amount referred to in present law as the "differential earnings amount." This reduction reflects the Congress's recognition that, to some extent, policyholder dividends paid by a mutual company are distributions of the company's earnings to the policyholders in their status as owners. The differential earnings amount is computed by multiplying a company's average equity base for the taxable year by a differential earnings rate.

The term equity base means an amount equal to the statutory surplus and capital of a company plus any nonadmitted financial assets, the excess of statutory reserves over tax reserves, the amount of any mandatory securities valuation reserve, deficiency reserve, or voluntary reserve (or similar liability), and 50 percent of

the amount of any provision for policyholder dividends (or other similar liability) payable in the following taxable year.

Explanation of Provision

The bill clarifies that no item shall be taken into account more than once in determining the equity base. This clarification is made to ensure that items which are specifically included in the equity base are not counted a second time because they may be indirectly included under another item which is included in the equity base. For example, deficiency reserves, which are specifically listed in the statute as included in the equity base, could also be included indirectly as part of the excess of statutory policy reserves over tax reserves, which is also specifically included in the equity base.

5. Definition of 50 largest stock companies (sec. 1821(e) of the bill and sec. 809(d)(4) of the Code)

Present Law

Under present law, the differential earnings amount which reduces a mutual company's policyholder dividends deduction is determined by multiplying the company's average equity base for the taxable year by the differential earnings rate for the taxable year. The differential earnings rate is the excess of an imputed earnings rate over the average mutual earnings rate. The imputed earnings rate is set in the Code and subsequently adjusted to provide comparable treatment for stock and mutual companies.

For taxable years beginning after 1984, the imputed earnings rate will be an amount which bears the same ratio to 16.5 percent as the current stock earnings rate (i.e., the numerical average of the rates of return for the 50 largest stock life insurance companies for the 3 years preceding the taxable year) bears to the base period stock earnings rate (i.e., the numerical average of the rates of return for the 50 largest stock companies for 1981, 1982, and 1983). The 50 largest stock companies are to be determined by the Secretary of the Treasury on the basis of gross assets; for these purposes, assets of a company among the 50 largest will be aggregated with assets of any affiliated life companies. However, in order to eliminate distortions in the computation of the average earnings rate of the 50 largest stock companies, the Secretary has the authority to omit from such computation companies with aberrational rates caused by disproportionately small equity bases (for example, when a company is close to being, or is, insolvent).

Explanation of Provision

The bill modifies the authority of the Secretary of the Treasury to issue regulations that would exclude companies from the 50 largest stock companies. Under the bill, any company that has a negative equity base is excluded from the 50 largest stock companies. In addition, regulations could exclude additional companies from the 50 largest stock companies if the exclusion of those companies would, by reason of their small equity bases, seriously distort the stock earnings rate. An unlimited number of stock companies could

be excluded from the group by reason of their having a negative equity base. However, no more than two companies could be excluded from the group of 50 largest stock companies by reason of the fact that their earnings rate could seriously distort the stock earnings rate. In addition, distorting companies could be excluded from the group of 50 largest stock companies only if their exclusion, in addition to the exclusion for the negative equity companies, would not cause the total number of stock companies to be excluded to exceed two.

The bill provides that a company will be removed from the group of 50 largest stock companies for the base period if such company had a negative equity base for 1981, 1982, or 1983 because such company's earnings rate would seriously distort the average stock earnings rate and if the company was a party to a rehabilitation proceeding on March 15, 1984, under the applicable State insurance law.

6. Clarification of statement gain or loss from operations (sec. 1821(f) of the bill and sec. 809(g)(1) of the Code)

Present Law

Under present law, the earnings rate for any life insurance company is the percentage, determined by the Secretary of the Treasury, which a company's statement gain or loss from operations is of its average equity base. Present law provides that the term "statement gain or loss from operations" means the net gain or loss from operations required to be set forth in the annual statement (a) determined with regard to policyholder dividends (as defined in section 808), but without regard to Federal income taxes, (b) determined on the basis of tax reserves rather than statutory reserves, and (c) properly adjusted for realized capital gains or losses and other relevant items.

Explanation of Provision

The bill revises the definition of statement gain or loss from operations to clarify that the term refers to net gain or loss from operations set forth in the annual statement, determined without regard to Federal income taxes and with further adjustment for certain items. Specifically, the bill clarifies that the "statement gain or loss from operations" must be adjusted by substituting for the amount shown on the annual statement for policyholder dividends the amount of the deductions for policyholder dividends under section 808, before reduction by any differential earnings amount (i.e., without regard to sec. 808(c)(2)). The use of the tax amount for the policyholder dividends deduction unreduced by any differential earnings amount is necessary to eliminate a circularity in computation of the differential earnings amount and to ensure that subsequent adjustments in the differential earnings amount have the revenue impact intended by the ownership differential provision.

7. Effect of differential earnings amount on estimated tax payments (sec. 1821 (g) and (h) of the bill and sec. 809(c) and (f) of the Code)

Present Law

Under present law, the differential earnings amount which reduces a mutual company's policyholder dividends deduction is determined by multiplying a company's average equity base for the taxable year by the differential earnings rate for the taxable year. The differential earnings rate is the excess of an imputed earnings rate over the average mutual earnings rate. The imputed earnings rate is set in the Code and subsequently adjusted to provide comparable treatment for stock and mutual companies.

The differential earnings rate for the taxable year is published by the Secretary of the Treasury after all the relevant data and computations have been made.

The differential earnings amount for any taxable year will be recomputed when sufficient tax return information is available to determine the average mutual earnings rate for the calendar year in which the taxable year begins. Thus, the recomputed differential earnings rate for 1984 will be determined after the tax returns for 1984 are filed, and will be based on the average mutual earnings rate for 1984. If the recomputed differential earnings amount computed with respect to a given taxable year exceeds the differential earnings amount reported on the company's tax return for that year, then the excess is required to be included in taxable income in the succeeding taxable year (1985, with respect to the recomputed differential earnings rate for 1984). Similarly, if the recomputed differential earnings amount computed with respect to a taxable year is less than the differential earnings amount reported for that year, then the difference will be allowed as a deduction in the subsequent taxable year.

Explanation of Provision

The bill amends the definition of the differential earnings rate to be used for a taxable year solely for purposes of estimated tax payments. Specifically, the bill provides that if, with respect to any installment of estimated tax, the differential earnings rate for the second preceding year is less than the differential earnings rate applicable to the taxable year for which the installment is paid, then for purposes of applying additions to tax for underpayments of estimated tax with respect to such installment, the amount of tax shall be determined by using the differential earnings rate for such earlier year.

In providing this relief from additions to tax for underpayments of estimated tax under these limited circumstances, the committee recognizes that, as a practical matter, the Secretary of the Treasury will be unable to collect the data from the previous taxable year and compute the new differential earnings rate for the current taxable year in time for the taxpayer to use that differential earnings rate to make its initial estimated tax payments.

The bill also clarifies that the recomputation of the differential earnings amount with respect to any taxable year will not affect

the liability for estimated tax payments for the taxable year in which the recomputed amount is included in (or deducted from) income. Thus, a mutual company will compute its tax liability for 1984 by using the statutory transitional differential earnings rate of 7.8 percent. If the recomputed differential earnings rate for 1984 exceeds 7.8 percent, then the company will be required to include in income in 1985 the excess of the recomputed differential earnings amount over the differential earnings amount reported on its tax return. As a practical matter, Treasury will be unable to collect the data for 1984 and compute the 1984 rate before 1986. Accordingly, this excess will not affect the company's estimated tax liability, or penalties relating to that liability, for 1985.

8. Amendments related to proration formulas (sec. 1821(i) of the bill and sec. 812 of the Code)

Present Law

Present law retains a prior law concept that items of investment yield should be allocated between policyholders and the company. Because reserve income increases may be viewed as being funded proportionately out of taxable and tax-exempt income, the net increase and net decrease in reserves are computed by reducing the ending balance of the reserve items by the policyholders' share of tax-exempt interest. The policyholders' share of any item is 100 percent of the item reduced by the company's share of the item. The company's share is defined as the percentage obtained by dividing the company's share of net investment income by total net investment income. Net investment income is defined as 90 percent of gross investment income. Gross investment income is generally all income from investments, including tax-exempt interest, and not including 100-percent dividends except to the extent such dividends are paid directly or indirectly out of tax-exempt income.[8] The definition of net investment income as 90 percent of gross investment income was believed to reflect generally the historical level of industry investment expenses.

The company's share of net investment income is the excess of net investment income over the sum of: (1) required interest (at the prevailing State assumed rate) for reserves; (2) the deductible portion of any excess interest; (3) the deductible portion of any amount in the nature of interest (whether or not a policyholder dividend) credited to a policyholder or customer fund under a pension plan contract for employees not yet retired or to a deferred annuity contract before the annuity starting date and not taken into account in (1) or (2); and (4) a fraction (referred to as the "minifraction") of the deductible portion of policyholder dividends (not including the deductible portion of any amounts previously included under (1), (2), or (3), and not including the deductible portion of any premium or mortality charge adjustments associated with a contract for which excess interest was credited during the taxable year).

The deductible portion of any policyholder dividend is that portion remaining after a pro-rata reduction of all policyholder divi-

[8] 100-percent dividends are those which would be eligible for the 100-percent dividends-received deduction, assuming the recipient is not a foreign corporation.

dends by the differential earnings amount under section 809 (if applicable). The fraction of the deductible portion of policyholder dividends to be included is determined by applying the minifraction. The numerator of the minifraction is gross investment income (including tax-exempt income), less required interest, excess interest and the amounts credited to pension plan contracts and deferred annuities (items (1), (2), and (3) described above). The denominator of the minifraction is gross income (including tax-exempt income), less net increases in reserve items.

Explanation of Provision

The bill amends the definition of required interest to provide that, if the prevailing State assumed interest rate is not used, another appropriate rate is to be used in calculating required interest.

Under the bill, the definition of the company's share of net investment income is amended to clarify that, in arriving at such amount, net investment income should be reduced by all interest paid to a depositor or any customer for the services provided by the life insurance company, whether it is interest guaranteed on the contract (like required interest) or excess interest. For example, net investment income should be reduced by all interest paid on deposit administration contracts that provide no permanent purchase rate guarantees; although the purchaser of such a contract may not technically be a "policyholder," the purchaser may be viewed as a depositor or a customer for the services provided by the life insurance company.

The bill eliminates a circularity problem existing under the language of present law in determining the minifraction to be used for purposes of computing the gross investment income's proportionate share of policyholder dividends. Specifically, the bill redefines the denominator of the minifraction to be life insurance gross income reduced by the excess (if any) of the closing balance for the reserve items described in section 807(c) over the opening balance for such items for the taxable year. It further generally states that, for purposes of computing the denominator, life insurance gross income shall be determined by including tax-exempt interest (as under present law) and by computing any decreases in reserves without any reduction of the closing balance of the reserve items by the company's share of tax-exempt interest.

In addition, the bill refines the definition of net investment income to take into account the fact that investment expenses with respect to assets held in segregated asset accounts have historically been smaller than those with respect to general account assets. Accordingly, in the case of gross investment income attributable to assets held in segregated asset accounts underlying variable contracts, the bill defines net investment income to mean 95 percent, rather than 90 percent, of gross investment income.

Finally, for purposes of computing net increases or decreases in reserves and for purposes of the proration formula, the bill provides that the terms "gross investment income" and "tax-exempt interest" shall not include any interest received with respect to a securities acquisition loan (an ESOP loan) as defined in section

133(b) of the Code. Also, for purposes of determining the gross investment income's proportionate share of policyholder dividends, "life insurance gross income" shall not include the interest on a securities acquisition loan. This amendment more fully implements the intention of Congress when it provided an exclusion from gross income for 50 percent of the interest received on a securities acquisition loan, that is, to encourage financial institutions to make loans to ESOPs and to employers who maintain leveraged ESOPs.

9. Treatment of foreign life insurance companies (sec. 1821(j) of the bill and sec. 813(a) of the Code)

Present Law

In general, under present law, foreign corporations are subject to U.S. tax only on certain U.S.-source income and on income that is effectively connected with a trade or business conducted in the United States. A foreign corporation carrying on an insurance business within the United States, which would qualify as a life insurance company if it were a U.S. corporation, is taxable like a U.S. life insurance company on its income effectively connected with its conduct of any U.S. trade or business. The determination of whether a foreign corporation would qualify as a life insurance company considers only the income of the corporation that is effectively connected with the conduct of its business carried on in the United States.

A special rule alters the U.S. tax on foreign life insurance companies doing business in the United States if they hold a relatively small surplus in the United States. If a foreign life insurance company's surplus held in the United States is less than a specified minimum amount, then the company must incregase its income by the product of (1) the excess of the required minimum surplus over actual surplus, and (2) its current investment yield.

Explanation of Provision

The bill clarifies how a foreign life insurance company doing business in the United States should compute its life insurance company taxable income if additional income has been imputed because actual surplus held in the United States is less than the required minimum surplus. Specifically, any amount of income imputed by the special adjustment to income under section 813 shall be added to life insurance gross income (before computing the amount of the special life insurance company deduction and the small life insurance company deduction), and such increase in income shall be included in gross investment income.

10. Treatment of certain distributions to shareholders from pre-1984 policyholders surplus account (sec. 1821(k) of the bill and sec. 815 of the Code)

Present Law

In general, present law eliminated any further deferral of tax through additions to a policyholders surplus account with regard to income for 1984 and later years. Although companies are not able

to enlarge their policyholders surplus account after 1983, they will not be taxed on previously deferred amounts unless such amounts are treated as distributed to shareholders or are subtracted from the policyholders surplus account under rules that are comparable to those provided under the 1959 Act, but that reflect the basic changes in the tax structure under the 1984 Act.

Present law provides that any direct or indirect distribution to shareholders from an existing policyholders surplus account of a stock life insurance company will be subject to tax at the corporate rate in the taxable year of distribution. For these purposes, the term distribution includes actual or constructive distributions.[9] When there are distributions from the policyholders surplus account, the amount of the distribution (whether actual or deemed, or by the indirect use of amounts in the policyholders surplus account for the benefit of shareholders) is taxed in addition to life insurance company taxable income (LICTI) and not as part of the LICTI computation. Thus, distributions from the policyholders surplus account cannot be offset by life insurance company losses and are not subject to the special and small life insurance company deductions.

Explanation of Provision

The citation in the legislative history of the 1984 Act to *Union Bankers Insurance Company* indicated the type of fact situations in which liability for a tax on distributions from a policyholders surplus account could arise. The present law emphasis on taxing both direct and indirect distributions from the policyholders surplus account was intended to be construed more broadly than under the 1959 Act, causing certain uses of policyholders surplus account funds to be treated as a distribution therefrom, whether or not there was a distribution under general corporate tax provisions.

The bill clarifies what would constitute an indirect distribution from the policyholders surplus account by providing that a direct or indirect distribution does not include a bona fide loan with arm's-length terms and conditions. An indirect distribution will be treated as occurring whenever policyholders surplus account funds are used to benefit the shareholders indirectly. For example, this may occur by using such funds to purchase stock of a parent or an affiliated company or by using such funds to make loans within an affiliated group for less than adequate consideration. Whether or not a loan is made with arm's-length terms and coonditions may be determined by reference to section 482 (relating to the allocation of income and deductions among taxpayers) and the regulations thereunder.

In the case of any loan made before March 1, 1986, the amount that will be treated as an indirect distribution from the policyholders surplus account due to the absence of arm's length terms and conditions will be limited to the foregone interest on the loan. The amount of foregone interest will be determined by using the lowest rate which would have met the arm's length requirements for a loan with the same terms and conditions. This rule continues to

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[9] See *Union Bankers Insurance Company* v. *Commissioner*, 64 T.C. 807 (1975).

apply unless the loan is renegotiated, extended, renewed, or revised on or after March 1, 1986.

The bill also reinstates a prior law provision (section 819(b)) which provides rules applicable to distributions from policyholders surplus accounts of foreign life insurance companies doing business in the United States.

11. Treatment of deficiency reserves (sec. 1821(l) of the bill and sec. 816 of the Code)

Present Law

Because of a general change in State law, as well as new rules for computing tax reserves, a prior law provision that specifically excluded deficiency reserves from the definition of life insurance reserves and total reserves was eliminated. Instead, the present law rules for computing tax reserves prohibit a company from taking into account any State requirements for "derficiency reserves" caused by a premium undercharge for purposes of computing the company's increases or decreases in life insurance reserves.

Explanation of Provision

The bill reinstates the prior-law exclusion of deficiency reserves from the definition of life insurance reserves and total reserves for purposes of section 816, which defines a life insurance company, and section 813(a)(4)(B), which defines surplus held in the United States for foreign lifes insurance companies doing business in the United States. The exclusion of deficiency reserves under DEFRA was not intended to have a substantive effect on the qualification of a company as a life insurance company or on the computation of surplus held in the United States for foreign life insurance companies.

12. Treatment of certain nondiversified contracts (sec. 1821(m) of the bill and sec. 817(h) of the Code)

Present Law

Present law provides special rules for variable life insurance or annuity contracts, or pension plan contracts with reserves based on segregated asset accounts (generally referred to as variable contracts). In addition to the rules for separate accounting with respect to variable contracts, present law grants the Secretary of the Treasury regulatory authority to prescribe diversification standards for investments of segregated asset accounts underlying variable contracts.

In addition, present law includes specific statutory diversification guidance for segregated accounts that are at least as diversified as regulated investment companies (if no more than 55 percent of assets are held in cash items, government securities, and securities of regulated investment companies), for variable life insurance contracts based on investments in Treasury securities, and for segregated accounts using investment funds that are not available to the public. If a segrevgated asset account underlying a variable contract does not meet the prescribed diversification standards, the

contract will not be treated as an annuity or as life insurance for tax purposes.

Under present law, the beneficial interest in a regulated investment company is not treated as one investment if all of the beneficial interests in such company or trust are held by one or more segregated asset accounts of one or more insurance companies. Thus, a segregated asset account is treated as owning a pro-rata share of the underlying investments in the regulated investment company or trust.

Explanation of Provision

The bill clarifies the exception for variable life insurance contracts based on investments in Treasury securities. Generally, the investments made by any segregated asset account with respect to a variable life insurance contract will be treated as adequately diversified to the extent invested in securities issued by the United States Treasury. The committee intends that the Treasury Department, in issuing regulations relating to the adequate diversification requirement, will provide guidance as to how the diversification requirement applies to the assets of the segregated asset account that are not invested in securities issued by the United States Treasury.

In addition, the bill provides that, if all the beneficial interests in a regulated investment company or any trust are held by one or more (a) insurance companies (or affiliated companies) in their general account or in segregated asset accounts, or (b) fund managers (or affiliated companies) in connection with the creation or management of the regulated investment company or trust, the diversification requirements shall be applied by taking into account the assets held by such regulated investment company or trust. This revision of the present law "look through" rule generalizes and broadens the statutory language to allow for the ownership of fund shares by an insurance company or fund manager for administrative convenience, in operating an underlying investment fund.

The committee intends that, for purposes of determining whether a variable contract is adequately diversified, the types of situations grandfathered in Rev. Ruls. 77-85, 80-274, and 81-225 will continue to be grandfathered under Treasury regulations. Further, the committee expects that the Treasury Department will provide a reasonable time after issuance of regulations relating to the diversification requirements during which an insurance company that relied on private letter rulings issued under the guidelines of those revenue rulings can diversify the assets of a segregated asset account.

13. Treatment of certain deferred compensation plans (sec. 1821(n) of the bill and sec. 818(a)(6)(A) of the Code)

Present Law

Diversification requirements prescribed by Treasury for segregated asset accounts underlying variable contracts do not apply with respect to pension plan contracts. Pension plan contracts refer generally to contracts used for qualified pension, profit-sharing, and stock bonus plans, qualified annuity plans, individual retirement

accounts, or governmental plans (within the meaning of sec. 414(d)) which provide retirement benefits.

Explanation of Provision

The bill clarifies the definition of a pension plan contract to include an eligible State deferred compensation plan (within the meaning of sec. 457(b)).

14. Dividends within affiliated group (sec. 1821(o) of the bill and sec. 818(e) of the Code)

Present Law

In addition to the general rules applicable to affiliated groups filing consolidated returns, present law provides a specific rule that, if an election to file a consolidated return is in effect with respect to an affiliated group for the taxable year, all items of the members of such group which are not life insurance companies shall not be taken into account in determining the amount of the tentative LICTI of members of such group which are life insurance companies.

Present law, as adopted under the 1984 Act, omitted a prior-law provision (prior law sec. 818(f)(1)) that provided a special rule for a life insurance company filing or required to file a consolidated return. Generally, this provision required that a company compute its policyholders' share of investment yield as if such company were not filing a consolidated return.

Explanation of Provision

The bill reinstates the prior-law provision of section 818(f)(1) with minor modifications to reflect changes in the general tax structure for life insurance company taxation. The bill provides that, in the case of a life insurance company filing or required to file a consolidated return with respect to any affiliated group for any taxable year, any determination under part I of subchapter L with respect to any dividend paid by one member of such group to another member of such group shall be made as if such group was not filing a consolidated return. This reinstatement of the prior-law provision is necessary to maintain the integrity of the proration rule for tax-exempt interest and the intercorporate dividend deduction between policyholders and the company.

15. Treatment of dividends from subsidiaries (sec. 1821(p) of the bill and sec. 805(a)(4) of the Code)

Present Law

In general, the deduction for intercorporate dividends received by a life insurance company is prorated between the company and the policyholders in proportion to the company's share and the policyholders' share of net investment income. However, "100 percent dividends" generally are not subject to proration except to the extent that they are attributable to tax-exempt interest or dividends that would not qualify as 100 percent dividends in the hands of the taxpayer. This limited proration of "100 percent dividends"

applies whether the corporation making the distribution is a life insurance company or a corporation not taxed as a life insurance company.

Explanation of Provision

The bill adds a special rule in the case of certain 100 percent dividends received from a life insurance subsidiary. Under the bill, in the case of any 100 percent dividend paid to a life insurance company for any taxable year after December 31, 1983, by another life insurance company, a portion of the deduction under sections 243, 244, or 245(b) (as the case may be) is disallowed if the payor company's share determined under the proration rules exceeds the payee company's share for the payee company's taxable year in which the dividend is received or accrued.

The portion of the deduction that is disallowed is the percentage obtained by subtracting the payee company's share from the payor company's share multiplied by the portion of the dividend attributable to prorated amounts. Prorated amounts include tax-exempt interest income and dividends other than 100 percent dividends.

In determining the portion of a dividend attributable to prorated amounts, any dividend by the payor company is treated as coming first out of earnings and profits for taxable years beginning after December 31, 1983, attributable to prorated amounts. In addition, the portion attributable to prorated amounts is calculated by determining the portion of earnings and profits attributable to prorated amounts without any reduction for Federal income taxes.

16. Special rule for application of high surplus mutual rules (sec. 1821(q) of the bill and sec. 809(i) of the Code)

Present Law

The Act provides a 5-year transition rule for high surplus mutual life insurance companies for purposes of applying the ownership differential provision. A company is a high surplus company if its equity base to asset ratio for 1984 exceeds a specified percentage of assets. A high surplus company need not apply the differential earnings rate to the excess portion of its equity base. The amount of any excess equity not taken into account in applying the differential earnings rate will decrease ratably each year, until 1989 when the entire equity base of a high surplus company is subject to the differential earnings rate. The amount of excess equity taken into account by any mutual life insurance company for any year (before being phased down ratably over the 5-year period of the transitional rule) cannot exceed the amount of the excess equity determined for 1984.

For purposes of determining whether a company is a high surplus company, the assets taken into account in the equity to asset ratio include all assets (e.g., certain nonadmitted assets) taken into account in determining its equity base including any additional equity attributed to the mutual because of the rules for the treatment of stock life companies owned by mutual life insurance companies. Thus, all the assets of any life insurance subsidiary whose equity is included in equity of the parent mutual company, as well

as any assets of separate asset accounts, are included in assets for purposes of applying the high surplus transitional rule.

Explanation of Provision

Under the bill, in the case of any mutual life insurance company that acquired a stock subsidiary during 1982 and whose excess equity base under section 809(i)(2)(D) of the Internal Revenue Code of 1954 is no more than 46 percent of such excess equity base (determined after the application of this provision limiting the company's excess equity base), the amount of the company's excess equity base for purposes of the high surplus mutual company rule is $122 million. This provision applies without regard to any other provision that would otherwise limit the company's excess equity base.

17. Clarification of denial of fresh-start provisions, application of 10-year spread and the effect of fresh start on earnings and profits (secs. 1822 (a), (d), and (e) of the bill and sec. 216(b)(1) and 216(b)(3) (A) and (C) of the Act)

Present Law

Under DEFRA, life insurance companies were required to revalue their reserves as of the beginning of the first taxable year beginning after December 31, 1983, according to newly prescribed reserve computation rules. Generally, any change in method of accounting or any change in the method of computing reserves which was required by the provisions in the Act was not to be treated as a change in method of accounting or in the method of computing reserves and thus not to give rise to income or loss. This gave life insurance companies a "fresh start" with respect to computing their life insurance reserves.

However, the fresh-start provision did not apply to any reserve transferred pursuant to a reinsurance agreement entered into, or a modification of a reinsurance agreement made, after September 27, 1983 (the date the fresh start provision was adopted by the Subcommittee on Select Revenue Measures of the House Ways and Means Committee) and before January 1, 1984 (the effective date of the new provisions). Likewise, the fresh start benefits did not apply to any reserve strengthening reported for Federal income tax purposes after September 27, 1983, for a taxable year ending before January 1, 1984. For these purposes, the phrase "any reserve strengthening" included the computation of reserves on contracts issued in 1983 at an interest rate that was lower than the rate normally assumed in computing reserves for similar contracts.

Further, under DEFRA, in the case of any item to which the fresh start had been denied, such item was taken into account for the first taxable year beginning after December 31, 1983 (in lieu of over the 10-year period otherwise provided under present law), unless the item was required to have been taken into account over a period of 10 taxable years under prior law.

Explanation of Provision

The bill clarifies that, with respect to reserves for which the fresh start is denied, the present-law rule for spreading a change in

basis of computing reserves over a 10-year period will be applied to the extent that the reserve change would have been required to be taken into account over a 10-year period under prior law. With respect to reserves for which the fresh start has been denied, that portion of the reserve change attributable to the repeal of an election under 818(c) is taken into account in the first taxable year beginning after December 31, 1983, and is not spread over a 10-year period.

In addition, the bill conforms the closing date for the period for which proscribed reinsurance transactions will result in a denial of the "fresh start" to that date given for revaluation of reserves. Specifically, it provides that for purposes of the denial of fresh start provision (sec. 216(b)(3)(A) of DEFRA), if a reinsurer's taxable year is not a calendar year, the first day of the first taxable year beginning after 1983 is the closing date of the period. This is intended to prevent abuse of the fresh-start provisions by use of reinsurance transactions after 1983 where the reinsurer's taxable year may be a fiscal year rather than the calendar year.

The bill clarifies that the change in the insurance company's reserves attributable to the "fresh start" will be taken into account in computing the current and accumulated earnings and profits of the insurance company. Under the general rule, this adjustment to an insurance company's earnings and profits will be made as of the beginning of the first taxable year beginning after December 31, 1983.

The committee intends that the adjustment to earnings and profits is to be taken into account by the taxpayer for whom the fresh-start adjustment is relevant. For example, if a life insurance subsidiary was sold by a controlled group in 1984, the adjustment to earnings and profits should be taken into account with respect to the subsidiary before the sale of the subsidiary because the amount of the fresh-start adjustment is essentially determined as of the beginning of the first taxable year beginning after December 31, 1983. Thus, the seller, rather than the purchaser, would benefit by the adjustment to earnings and profits.

An exception to the general rule is provided to the general rule relating to the adjustment to earnings and profits in the case of an insurance company that (1) is a member of a controlled group the common parent of which is a company having its principal place of business in Alabama and (2) was incorporated in Delaware on November 29, 1979. In this situation, the adjustment to the insurance company's earnings and profits will be made as of the beginning of the company's first taxable year beginning after December 31, 1984.

18. Treatment of certain elections under sec. 818(c) (sec. 1822(b) of the bill and sec. 216(b)(4)(B) of the Act)

Present Law

The Act provided that, except in a limited situation, any election after September 27, 1983, under prior-law section 818(c) to revalue preliminary term reserves to net level reserves would not take effect. An election under prior-law section 818(c) was allowed to take effect after September 27, 1983, if more than 95 percent of the

reserves computed in accordance with such election were attributable to risks under life insurance contracts issued by the taxpayer under a plan of insurance first filed after March 1, 1982, and before September 28, 1983.

The legislative history describing the denial of fresh start provisions described reserve strengthening as also including generally an election under prior-law section 818(c) which was made after September 27, 1983.

Explanation of Provision

The bill clarifies that a valid prior-law section 818(c) election made under the exception described above shall not be treated as reserve strengthening for purposes of denying a fresh start and requiring that the amount be taken into income in the first taxable year beginning after December 31, 1983. This allows a taxpayer that qualifies for the limited exception for making a prior-law section 818(c) election after September 27, 1983, to have the full benefit of that election.

In addition, the bill provides a limited exception to the rule requiring section 818(c) elections to have been made on or before September 27, 1983. Under this exception, an election is treated as if it were made on or before September 27, 1983, if (1) on or before December 31, 1983, a qualified stock purchase (as defined in sec. 338(d)(3)) was made with respect to a life insurance company that had in effect a valid section 818(c) election before September 27, 1983, (2) an election under section 338 is made with respect to the company, and (3) a new section 818(c) election with respect to the new corporation (described in sec. 338(a)(2)) is made with respect to the corporation's taxable year beginning on the date of acquisition. The committee intends that no inference is to be drawn with respect to the treatment of an election under section 338 to increase the basis of any assets acquired by the amount of reserve liabilities assumed in connection with the acquisition.

19. Election not to have reserves recomputed (sec. 1822(c) of the bill and sec. 216(c) of the Act)

Present Law

Under the Act, certain qualified life insurance companies can elect not to recompute reserves for existing contracts as of January 1, 1984, but to use their statutory reserves for all such contracts. In so using statutory reserves for tax purposes, a company elects to forgo the "fresh start" with respect to the difference between statutory reserves and the Federally prescribed reserves; there is still a "fresh start" with respect to the difference between statutory reserves and prior law tax reserves attributable to a prior law 818(c) election.

Also, as a transitional rule, any company that makes the above described election and that has tentative LICTI for its first taxable year after 1984 of $3 million or less may further elect to have the reserve for any contract issued on or after 1983 and before January 1, 1989, be equal to the statutory reserve for the contract computed for tax purposes with an adjustment similar to the geometric

Menge formula under TEFRA (sec. 805(c)(1) of prior law as in effect for 1982 and 1983).

These elections must be made at the time and in the manner prescribed by Treasury and, once made, are irrevocable.

Explanation of Provision

The provision in the bill makes it clear that in determining whether a company is eligible to make the election for contracts issued on or after 1983 and before January 1, 1989, a company must compute its tentative LICTI taking into account reserves as though the election was in effect. The bill also clarifies that the so-called geometric Menge adjustment should be applied to opening and closing statutory reserves, for purposes of computing net increases or decreases in life insurance reserves.

In addition, the bill provides that the reserve for a company making the election will be the greater of the company's statutory reserve (as adjusted by the geometric Menge adjustment) or the net surrender value of the contract.

20. Special rule for companies using net level reserve method for noncancellable accident and health insurance contracts (sec. 1823(a) of the bill and sec. 217(n) of the Act)

Present Law

Under present law, a company shall be treated as meeting the requirements of the Federally prescribed reserve method with respect to any noncancellable accident and health insurance contract for any taxable year if such company (1) uses the net level reserve method to compute its tax reserves on such contracts for such taxable year, (2) was using the net level reserve method to compute its statutory reserves on such contracts as of December 31, 1982, and (3) has continuously used such method for computing such reserves on such contracts after December 31, 1982, and through such taxable year.

In explaining this special rule, the legislative history of DEFRA stated that a company can use the net level reserve method for tax purposes for noncancellable accident and health contracts sold under a particular plan of insurance, if the company computed all its reserves for such contracts on that method for statutory purposes as of December 31, 1982, (as evidenced by its 1982 annual statement, as originally filed) and continues to do so for all such reserves on both new and existing business.[10] If the company was not using a net level reserve method as of the prescribed date, with respect to contracts sold under a particular plan of insurance, the company must use the generally prescribed reserve method (2-year full preliminary term method) for all contracts under the plan. Likewise, the generally prescribed method must be used for noncancellable accident and health insurance contracts sold under any new plans of insurance.

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[10] The Statement of Managers for DEFRA erroneously refers to 1983 in describing this part of the provision.

The legislative history limited the application of the rule to noncancellable accident and health contracts sold under currently marketed plans of insurance, but not under new plans of insurance. The practical consequences of this limiting language is that no company, even one meeting the otherwise strict qualification requirements, will elect to use the special rule because the detriment of forgoing the fresh start (because noncancellable accident and health reserves are not revalued) will not be offset by any favorable future reserve treatment for new product developments.

Explanation of Provision

The special rule of present law applicable to the use of the net level reserve method for noncancellable accident and health reserves was intended to be narrow in its application by requiring a complete and continuous commitment by the company to the use of the more conservative net level reserve method for its directly written noncancellable accident and health contracts as a reflection of the company's conservative business practices before a company could recognize such practices for tax purposes. Specifically, it was intended to address the factual situation of a company that has been predominantly a writer of noncancellable accident and health insurance and that had followed, and continues to follow, the business practice of computing all its reserves for directly written noncancellable accident and health contracts on a net level basis for State purposes. It was intended to allow such company to use this more conservative reserve basis for tax purposes.

Because the rule under present law is impractically narrow, and would not result in any taxpayer making the election, the bill expands the coverage of the rule to allow the net level reserve method for tax purposes on any directly written noncancellable accident and health insurance contract, whether under existing or new plans of insurance. For purposes of applying this special rule and qualifying therefor, only reserves on directly written contracts will be taken into account because, as a reinsurer, a company would generally adopt the reserve method used by the ceding company. This limited expansion will allow the special rule to have its intended practical effect.

Although present law requires that all reserves for noncancellable accident and health insurance contracts be computed on a net level basis for statutory purposes as of December 31, 1982, the bill adopts a de minimis margin for error for purposes of administrative convenience. Accordingly, in order to qualify for the application of this rule, a company must have been using the net level reserve method to compute at least 99 percent of its statutory reserves for directly written noncancellable accident and health insurance contracts as of December 31, 1982, and for the 1982 calendar year must have received more than half its premium income from directly written noncancellable accident and health insurance.

After December 31, 1983, the company will be treated as using the prescribed reserve method for a taxable year if through such taxable year, the company has continuously used the net level method for computing at least 99 percent of its tax and statutory

reserves on its directly written noncancellable accident and health contracts. This requires a complete and continuous use of the net level method for tax and statutory purposes for all but one percent of directly written noncancellable accident and health contracts; for contracts for which the company does not use the net level method, the company should use the method used for statutory purposes, for purposes of computing tax reserves.

21. Application of add-on tax where a substantial portion of a company's business is mortgage life insurance (sec. 1823(b) of the bill and sec. 809 of the Code)

Present Law

Under present law, for purposes of computing the differential earnings amount of a mutual company, the equity of a stock subsidiary is included in the parent's equity base (in lieu of the stock of the subsidiary).

For purposes of determining the statement gain from operations of the mutual parent, the mutual parent should ignore any dividends it received from the subsidiary. Also, for purposes of computing the average mutual earnings rate and the imputed earnings rate, life insurance subsidiaries of a mutual life insurance company will be counted as mutual companies.

This treatment is in contrast to the treatment of nonlife insurance subsidiaries, the stock of which will be included in the parent mutual company's equity and the earnings of which will only be taken into account in computing the average mutual earnings rate when and as dividends are received by the parent mutual company.

Explanation of Provision

Under the bill, in the case of a mutual company, the rules relating to the treatment of stock life subsidiaries are modified to provide (1) the equity (and the stock) of the subsidiary is not taken into account in determining the average equity base of the parent, (2) the subsidiary is taxed as a stock company, except that no deduction for policyholder dividends (as defined in section 808) is allowed, and (3) the subsidiary is not to be included among the group of 50 largest stock companies.

The treatment of such stock subsidiaries would be provided in the case of a certain mutual company.

A subsidiary for which the special rules apply is a subsidiary (1) at least 90 percent of the stock of which is owned by a mutual company that meets the description set forth above, and (2) a substantial portion of whose insurance business consists of direct writing of mortgage insurance or the reinsurance of mortgage insurance on which no policyholder dividends are paid. Mortgage insurance means insurance issued in whole or in part for the purpose of extinguishing outstanding indebtedness owed by the individuals insured.

The provision is effective for taxable years beginning after December 31, 1983. In addition, the equity base of the company (under sec. 809(b)), shall be reduced as of the close of taxable years 1982,

1984, and 1985 by the amount of capital and surplus of the qualified subsidiary as of December 31, 1986.

The committee is concerned that this provision not allow the average equity base of the parent mutual company to be reduced by an amount greater than the amount of equity necessary to the insurance operations of the stock subsidiary. Any equity in excess of the amount necessary to the insurance operations of the subsidiary, or any equity of the subsidiary used, directly or indirectly, for the benefit of the parent (for example, amounts loaned by the subsidiary to the parent or portions of the stock of the subsidiary used as collateral for borrowings by the parent) are to be included in the equity base of the parent. The committee expects the Internal Revenue Service to examine closely the amount of surplus and capital maintained by the subsidiary and any transfers of assets between parent and subsidiary.

In addition, the committee expects the Internal Revenue Service to treat any reinsurance agreement between the parent and subsidiary as not having a significant tax avoidance effect (within the meaning of section 845(b)), in the case of a reinsurance agreement under which the subsidiary (a) assumes all risks of the parent with respect to mortgage insurance on which no policyholder dividends are paid and (b) reimburses the parent for the expenses of selling such policies.

22. Underpayments of estimated tax (sec. 1824 of the bill and sec. 218 of the Act)

Present Law

Under present law, no addition to tax shall be made under the provision relating to failure by a corporation to pay estimated tax with respect to any underpayment of an installment required to be paid before the date of enactment of the Act to the extent that such underpayment was created or increased by any provision of the insurance tax subtitle and such underpayment is paid in full on or before the last date prescribed for payment of the first installment of estimated tax required to be paid after the date of the enactment of the Act.

Explanation of Provision

The bill repeals section 218 of the Act in favor of the application of the broader general relief granted by the bill under which no addition to tax shall be made for underpayments of estimated tax by corporations for any period before March 16, 1985 (by individuals, for any period before April 16, 1985), to the extent that such underpayment was created or increased by a provision of the 1984 Act.

23. Definition of life insurance contract; computational rules (sec. 1825(a) of the bill and sec. 7702(e)(1) of the Code)

Present Law

Under present law, a life insurance contract is defined as any contract, which is a life insurance contract under the applicable State or foreign law, but only if the contract meets either (1) a cash

value accumulation test, or (2) a test consisting of a guideline premium limitation requirement and a cash value corridor requirement. Under both tests, present law prescribes minimum interest assumptions and mortality assumptions that must be taken into account in computing the limitations.

Under the cash value accumulation test, the cash surrender value of the contract, by the terms of the contract, may not at any time exceed the net single premium which would have to be paid at such time in order to fund the future benefits under the contract assuming the contract matures no earlier than age 95 for the insured.

Under the guideline premium limitation/cash value corridor test, a contract will continue to be treated as life insurance so long as it does not violate its guideline premium limitation or the cash value corridor. A life insurance contract meets the guideline premium limitation if the sum of the premiums paid under the contract does not at any time exceed the greater of the guideline single premium or the sum of the guideline level premiums to such date.

In addition, present law provides three general rules or assumptions to be applied in computing the limitations set forth in the definitional tests. These computational rules restrict the actual provisions and benefits that can be offered in a life insurance contract only to the extent that they restrict the allowable cash surrender value (under the cash value accumulation tests) or the allowable funding pattern (under the guideline premium limitation). First, in computing the net single premium (under the cash value accumulation test) or the guideline premium limitation for any contract, the death benefit generally is deemed not to increase at any time during the life of the contract (qualified additional benefits are treated the same way). It is unclear under present law whether this computational rule applies for purposes of determining the satisfaction of the cash value corridor test.

Second, the maturity date, including the date on which any endowment benefit is payable, shall be no earlier than the day on which the insured attains age 95, and no later than the day on which the insured attains age 100. Third, the amount of any endowment benefit (or sum of endowment benefits, including any cash surrender value on the maturity date described in the second computational rule) shall be deemed not to exceed the least amount payable as a death benefit at any time under the contract.

Under present law, the term "premiums paid" means the premiums paid under the contract minus amounts (other than amounts includible in income) and any other amounts specified in regulations.

Explanation of Provision

The bill clarifies the second computational rule by specifically stating that the maturity date shall be deemed to be no earlier than age 95 and no later than age 100. This conforms the language of the second computational rule to that of the first and third.

The bill also adds an additional computational rule which provides that for purposes of applying the second computational rule and for purposes of determining the cash surrender value on the

maturity date under the third computational rule, the death benefits shall be deemed to be provided until the maturity date described in the second computational rule. This rule combined with the second computational rule will generally prevent contracts endowing at face value before age 95 from qualifying as life insurance. However, it will allow an endowment benefit at ages before 95 for amounts less than face value.

Finally, the bill amends the computational rules to clarify that these rules do not apply for purposes of determining qualification under the cash value corridor test.

24. Reduction in future benefits (sec. 1825(b) of the bill and sec. 7702(f)(7) of the Code)

Present Law

Under present law, proper adjustments must be made for any change in the future benefits or any qualified additional benefit (or any other terms) under a life insurance contract, which was not reflected in any previous determination made under the definitional section. Changes in the future benefits or terms of the contract can occur by an action of the company or the policyholder or by the passage of time. However, proper adjustments may be made for a particular change, depending on which alternative test is being used or whether the changes result in an increase or decrease of future benefits.

In the event of an increase in current or future benefits, the limitations under the cash value accumulation test must be computed by treating the date of change, in effect, as a new date of issue for determining whether the changed contract continues to qualify as life insurance under the definition prescribed under present law. Thus, if a future benefit is increased because of a scheduled change in death benefit or because of the purchase of a paid-up addition (or its equivalent) the change will require an adjustment in the new computation of the net single premium definitional limitation. Under the guideline premium limitation, an adjustment is required under similar circumstances, but the date of change for increased benefits should be treated as a new date of issue only with respect to the changed portion of the contract. Likewise, no adjustment shall be made if the change occurs automatically, for example, a change due to the growth of the cash surrender value (whether by the crediting of excess interest or the payment of guideline premiums) or changes initiated by the company. If the contract fails to meet the limitations after proper adjustments have been made, a distribution of cash to the policyholder may be required in order to maintain qualification of the contract as life insurance.

Under present law, the Secretary of the Treasury has authority to prescribe regulations governing how such adjustments in computations of the definitional limitations should be made. Such regulations may revise, prospectively, some of the adjustment rules described above in order to give full effect to the intent of the definitional limitations.

Further, for the purpose of the adjustment rules, any change in the terms of a contract that reduces the future benefits under the contract will be treated as an exchange of contracts (under section

1035). Thus, any distribution required under the adjustment rules will be treated as taxable to the policyholder under the generally applicable rules of section 1035. This provision was intended to apply specifically to situations in which a policyholder changes from a future benefits pattern taken into account under the computational provision for policies with limited increases in death benefits to a future benefit of a level amount (even if at the time of change the amount of death benefit is not reduced). If the adjustment provision results in a distribution to a policyholder in order to meet the adjusted guidelines, the distribution will be taxable to the policyholder as ordinary income to the extent there is income in the contract.

The provision that certain changes in future benefits be treated as exchanges was not intended to alter the application of the transition rules for life insurance contracts and only applies with respect to such changes in contracts issued after December 31, 1984. Likewise, this adjustment provision was not intended to repeal indirectly the application of section 72(e) to life insurance contracts.

Explanation of Provision

In general.—The bill modifies the provision of present law that governs how adjustments of future benefits will be treated under section 7702. The bill retains the requirement that, in determining whether the contract continues to qualify as life insurance, proper adjustments be made when future benefits are changed. However, the express delegation of authority to the Secretary of the Treasury to issue regulations governing adjustments has been deleted. In its place, the bill contains specific rules governing the extent to which a reduction in future benefits will cause income to be recognized to the policyholder.

Specifically, the bill provides that if there is a change in the benefits under (or in other terms of) the contract which was not reflected in any previous determination or adjustment made under the definitional section, there shall be proper adjustments in future determinations made under the definitional section. If the change reduces benefits under the contract, the adjustments may include a required distribution in an amount determined under the adjustment regulations for purposes of enabling the contract to meet the applicable definitional test. A portion of the distribution required by application of the definitional tests will be taxed as ordinary income to the extent there is income in the contract.

In stating the "income characterization" portion of the adjustment provision, the bill refers directly to the provisions governing the taxation of distributions from annuity and life insurance contracts, pointing out that the provision which allows withdrawals from life insurance contracts to be treated as withdrawal of investment first does not apply under certain circumstances.

Under the bill, a portion of the cash distributed to a policyholder as a result of a change in future benefits will be treated as being paid first out of income in the contract, rather than as a return of the policyholder's investment in the contract, only if the reduction in future benefits occurs during the 15-year period following the issue date of the contract.

Changes during first five years.—For the first five years following the issuance of the contract, the amount that will be treated as having been paid first out of income in the contract will be equal to the amount of the required distribution under subparagraph (A) of section 7702(f)(7). This amount will depend on whether the contract meets the cash value accumulation test or the guideline premium/cash value corridor test of section 7702(a). In the case of a contract to which the cash value accumulation test applies, the excess of the cash surrender value of the contract over the net single premium determined immediately after the reduction shall be required to be distributed to the policyholder. In the case of a contract to which the guideline premium/cash value corridor test applies, the amount of the required distribution is equal to the greater of (1) the excess of the aggregate premiums paid under the contract over the redetermined guideline premium limitation, or (2) the excess of the cash surrender value of the policy immediately before the reduction over the redetermined cash value corridor. The guideline premium limitation shall be redetermined by using an "attained-age-decrement" method.

Under this method, when benefits under the contract are reduced, the guideline level and single premium limitations are each adjusted and redetermined by subtracting from the original guideline premium limitation a "negative guideline premium limitation" which is determined as of the date of the reduction in benefits and at the attained age of the insured on such date. The negative guideline premium limitation is the guideline premium limitation for an insurance contract that, when combined with the original insurance contract after the reduction in benefits, produces an insurance contract with the same benefit as the original contract before such reduction.

To the extent that the redetermined guideline premium limitation requires a distribution from the contract, the amount of the distribution will also be an adjustment to premiums paid under the contract (within the meaning of sec. 7702(f)(1)(A), to be specified in regulations). It is understood that any adjustments to premiums paid as part of the definitional determinations will be independent of, and may differ in amount from, the determination of investment in the contract for purposes of computing the amount of income in the contract (under sec. 72).

Changes during years six to fifteen.—For cash distributions occurring between the end of the fifth year and the end of the fifteenth year from the issuance date of the policy, a single rule applies for all contracts. Under this rule, the maximum amount that will be treated as paid first out of income in the contract will equal the amount by which the cash surrender value of the contract (determined immediately before the reduction in benefits) exceeds the maximum cash surrender value that would not violate the cash value corridor (determined immediately after the reduction in benefits).

Distribution in anticipation of a reduction.—The bill also provides that certain distributions of cash made in anticipation of a reduction in benefits under the contract shall be treated as a cash distribution made to the policyholder as a result of such change in order to give full effect to the provision. Any distribution made up

to two years before a reduction in benefits occurs will be treated as having been made in anticipation of such a reduction. The Secretary of the Treasury is authorized to issue regulations specifying other instances when a distribution is in anticipation of a reduction of future benefits. In addition, the regulations may specify the extent to which the rules governing the calculation of the maximum amount that will be treated as paid first out of income in the contract will be adjusted to take account of the prior distributions made in anticipation of reduction of benefits.

Definition of premiums paid.—The bill modifies the definition of the term "premiums paid." Under the bill, premiums paid would be computed in the same manner as under present law, except that the premiums actually paid under the contract will be further reduced by amounts treated as paid first out of income in the contract under the revised adjustment rule. This reduction in premiums paid is limited to the amounts that are included in gross income of the policyholder solely by reason of the fact that a reduction in benefits has been made.

25. Treatment of contracts that do not qualify as life insurance contracts (sec. 1825(c) of the bill and sec. 7702(g) of the Code)

Present Law

If a life insurance contract does not meet either of the alternative tests under the definition of a life insurance contract, the income on the contract for the taxable year of the policyholder will be treated as ordinary income received or accrued by the policyholder during that year. For this purpose, the income on the contract is the amount by which the sum of the increase in the net surrender value of the contract during the taxable year and the cost of insurance protection provided during the taxable year exceed the amount of premiums paid less any policyholder dividends paid under the contract during the taxable year. The term premiums paid means the amount paid as premiums under a contract less amounts to which the rules for allocation between income and investment under annuity and other contracts in section 72(e) apply.

Explanation of Provision

Under the bill, income in the contract is computed without reduction by the amount of policyholder dividends paid under the contract during the taxable year. This change was necessary to avoid overstating the income in the contract, which otherwise would occur due to the fact that policyholder dividends are treated as a nontaxable return of basis under section 72(e) and reduce premiums paid directly. If these dividends were also added to the amount of income on the contract, income would be overstated because policyholder dividends would reduce premiums paid twice.

26. Treatment of flexible premium contracts issued during 1984 which meet new requirements (sec. 1825(d) of the bill and sec. 221(d)(1) of the Act)

Present Law

Under DEFRA, the new definition of life insurance generally applies to contracts issued after December 31, 1984, except in the case of certain increasing death benefit contracts issued after June 30, 1984. Also, the TEFRA provisions for flexible premium contracts (that is, prior-law sec. 101(f) applicable during 1982 and 1983) were extended through 1984.

Explanation of Provision

The bill clarifies the definition of life insurance transition rules so that any contract issued during 1984 which meets the definitional requirements of present-law section 7702 will be treated as meeting the requirements of prior-law section 101(f), which was extended through 1984.

27. Treatment of certain contracts issued before October 1, 1984 (sec. 1825(e) of the bill and sec. 221(d)(2)(C) of the Act)

Present Law

Under the Act, a transition rule was provided for certain increasing death benefit policies. This rule made the new definitional provisions of section 7702 applicable only for a contract issued after September 30, 1984, if (1) the contract would meet the new definition by substituting 3 percent for 4 percent as the minimum interest rate in the cash value accumulation test (assuming that the rate or rates guaranteed on issuance of a contract can be determined without regard to any mortality charges), and (2) if the cash surrender value of the contract did not at any time exceed the net single premium which would have to be paid at such time to fund future benefits at the then current level of benefits (with the same 3 percent for 4 percent substitution).

Explanation of Provision

The bill clarifies the transition rule so that, in applying the cash value accumulation test by substituting 3 percent for 4 percent as the minimum interest rate, the taxpayer should not only assume that the rate or rates guaranteed on issuance of the contract can be determined without regard to any mortality charges, but should also assume that the rate or rates should be determined without regard to any initial interest rate guaranteed in excess of the stated minimum rate.

28. Clarification of application of definition of life insurance (sec. 1825(f) of the bill and sec. 7702 of the Code)

Present Law

DEFRA adopted a definition of a life insurance contract for purposes of the Code. Under DEFRA, a life insurance contract is de-

fined as any contract, which is a life insurance contract under the applicable State or foreign law, but only if the contract meets either (1) a cash value accumulation test, or (2) a test consisting of a guideline premium requirement and a cash value corridor requirement.

It is unclear under present law whether the definition of a life insurance contract also extends to death benefits provided to employees through a self-insured (or self-funded) plan maintained by an employer. If the definition of a life insurance contract does not include a self-insured death benefit, then the death benefit provided to an employee's beneficiaries would not be eligible for the exclusion from gross income provided under section 101(a), but would be eligible for the $5,000 exclusion for death benefits (sec. 101(b)).

Under prior law, death benefit payments having the characteristics of life insurance were eligible for the exclusion from gross income under section 101(a), rather than under section (sec. 101(b)). The fundamental characteristics of a life insurance contract that were required to be met before the exclusion was available were that the contract (1) must shift the risk of economic loss caused by the premature death of the insured from the insured and the insured's family to the insurance program and (2) must distribute the risk of this economic loss among the participants in the program.[11] Although such an arrangement need not be in the form of a traditional bilateral agreement, or for that matter, even a unilateral one signed by one party and accepted by the other, it must be binding and enforceable.[12] Furthermore, the arrangement may not be a mere sham that provides inadequate available funds or that allows the nonpayment of benefit claims that are due.

In addition, under present law, except to the extent that coverage under a death benefit plan qualifies for the limited exclusion from gross income provided for group-term life insurance (sec. 79), the value of the coverage provided to an employee is includible in the employee's income for the period during which the coverage is provided. Thus, although the death benefits paid under such a plan are not includible in gross income, the value of the insurance coverage is currently taxable to the employee if the benefits have the characteristics of life insurance.

Explanation of Provision

The bill clarifies that the definition of a life insurance contract added by DEFRA was not intended to eliminate, with respect to a church plan (as defined in sec. 414(e)), the exclusion under section 101 for self-insured employer-provided death benefits which are properly treated as life insurance. Thus, the bill clarifies that the definition of a life insurance contract (sec. 7702) includes contracts provided under a employer plan, to the extent the requirements applicable to a life insurance contract are met. In addition, the committee does not intend to alter the rules under prior law relating to whether self-insured benefits are treated as a life insurance con-

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[11] *Helvering v. Le Gierse*, 312 US 531 (1941).
[12] *Ross v. Odom*, 401 F.2d 464 (5th Cir., 1968).

tract (i.e., the satisfaction of risk shifting and risk distribution requirements).

Finally, the committee reiterates that, unless a life insurance benefit is excludable as group-term life insurance (sec. 79), the value of the coverage is currently includible in an employee's income. If the value of coverage is not included in income (presumably because the death benefit program does not meet the requirements to be treated as life insurance), then the only exclusion applicable (as under present law) is the $5,000 exclusion available under section 101(b)).

29. Amendments related to annuity contracts (sec. 1826 of the bill and sec. 72(q) and (s) of the Code)

Present Law

Under present law, cash withdrawals prior to the annuity starting date are includible in gross income to the extent that the cash value of a contract (determined immediately before the amount was received and without regard to any surrender charge) exceeds the investment in the contract. A penalty tax of 5 percent is imposed on the amount of any such distribution that is includible in income, to the extent that the amount is allocable to an investment made on or after August 14, 1982. The penalty is not imposed if the distribution is made after the contractholder attains age 59½, when the contractholder becomes disabled, upon the death of the contractholder, or as payment under an annuity for life or at least 5 years.

An annuity contract must provide specific rules for distribution in the event of the contractholder's (owner's) death in order to be treated as an annuity contract for income tax purposes. These after-death distribution rules generally conform to those applicable to qualified pension plans and IRAs. To be treated as an annuity contract, the contract must provide that, if the contractholder dies on or after the annuity starting date and before the entire interest in the contract has been distributed, the remaining portion of such interest will be distributed at least as rapidly as under the method of distribution in effect before death. If the contractholder dies before the annuity starting date, the entire interest generally must be distributed within 5 years after the date of death of the contractholder, or must be annuitized for some period (including the life of a designated beneficiary) within one year after the date of death. For these purposes, the beneficiary is the person who becomes the new owner of the annuity contract and controls the use of the cash value of the contract.

If there is a spousal beneficiary, the contract (including deferral of income tax) may be continued in the name of the spouse as the contractholder upon the contractholder's death. Thus, a spousal beneficiary steps into the shoes of the decedent contractholder.

To the extent that the terms used refer to individuals (e.g., death, spouse, or age), the provisions apply only to individual contractholders (owners) of annuity contracts. A person who holds legal title to an annuity contract in a representative capacity, such as a custodian or trustee, is not treated as the contractholder. Rather, the beneficial owner of the contract is the holder.

Explanation of Provision

The bill clarifies that the requirement that the annuity contract include required distribution provisions in order to be treated as an annuity need not be met by contracts which are used as part of a qualified pension plan or for an IRA by adopting a specific statutory exemption for these purposes. This provision is added because annuity contracts provided under a qualified pension plan or an IRA must satisfy the required distribution rules applicable to such plans and should not be required to satisfy an essentially duplicative set of rules applicable to annuity contracts.

In addition, the bill includes special rules to clarify the application of the required distribution rules if the contractholder is not an individual, which provide that the primary annuitant shall be treated as the holder of the contract. For these purposes, the term "primary annuitant" means the individual, the events in the life of whom are of primary importance in affecting the timing or amount of the pay-out under the contract. For example, the primary annuitant would be that person referred to in the contract as the measuring life for the annuity starting date or for annuity benefits payable under the contract.

Likewise, the bill clarifies the application of the penalty exception for distributions at death so that the penalty does not apply to any distribution made on or after the death of the contractholder or, if the contractholder is not an individual, the death of the primary annuitant. Thus, the additional income tax on early withdrawals (sec. 72(q)) is not imposed on an after-death distribution required under section 72(s).

The bill also adds a provision which states that if an individual who holds an annuity contract transfers it by gift or, in the case of a holder which is not an individual, if there is any change in the primary annuitant, then such transfer or change shall be treated as an assignment of the contract (sec. 72(e)(4)), which treats the amount assigned as received as an amount not received as an annuity. In general, the value of the contract assigned will equal the net surrender value of the contract, determined with regard to any policy loan. The investment in the contract of the grantee (or the adjusted investment in the contract of the nonindividual holder) will be treated as equal to the investment in the contract of the grantor plus the amount included in the gross income of the grantor.

Without the clarification treating gratuitous transfers of annuity contracts as assignments, the required distribution rules adopted in the 1984 Act could be avoided easily because they would allow taxpayers to continue tax deferral beyond the life of an individual taxpayer. There is an exception to the rule for transfers of annuity contracts by gift where the transfer is made to a spouse. Specifically, the contract will not be treated as assigned with respect to any transfer to which section 1041(a) (relating to transfers of property between spouses or incident to divorce) applies.

In addition, the bill addresses the issue of how joint contractholders should be treated when one holder dies and clarifies that the after-death distribution requirements apply upon the death of any holder to such contract.

In order to allow annuity writers time to make changes conforming to the clarifications contained in this bill, these provisions shall apply to contracts issued after the date which is 6 months after the date of enactment of the bill.

Finally, the bill provides that any annuity used as a qualified funding asset in a structured settlement will not be subject to the 5 percent additional income tax imposed on the portion of any premature distribution from an annuity that is included in gross income.

30. Amendments related to group-term insurance (sec. 1827 of the bill and secs. 79 and 83(e) of the Code)

Present Law

Under present law, the cost of group-term life insurance purchased by an employer for an employee for a taxable year is included in the employee's gross income to the extent that the cost is greater than the sum of the cost of $50,000 of life insurance plus any contribution made by an employee to the cost of the insurance. The $50,000 cap on the group-term life insurance exclusion is applicable to active employees and to former employees other than employees who have terminated employment because of disability. Generally, the cost of group-term life insurance is determined on the basis of uniform premiums, computed with respect to 5-year age brackets, under a table prescribed by the Secretary of the Treasury.

If a group-term life insurance plan maintained by an employer discriminates in favor of any key employee, the exclusion for the cost of the first $50,000 of this insurance is further limited. In the case of a discriminatory plan, the full cost of the group-term life insurance for any key employee is included in the gross income of the employee at actual cost, rather than the table cost.

The DEFRA amendments relating to group-term life insurance were effective for taxable years beginning after December 31, 1983. The provisions do not apply with respect to certain grandfathered individuals who receive group-term life insurance under a plan in existence on January 1, 1984 (or under a comparable successor plan).

Explanation of Provision

The bill provides that, in the case of a discriminatory group-term life insurance plan, the cost of group-term life insurance on the life of any key employee shall be the greater of the actual cost of the insurance or the cost determined based on the uniform premium table. The present-law requirement that key employees include in gross income the actual cost of their coverage under discriminatory plans was intended to discourage further use of discriminatory group-term life insurance plans. This requirement would only tend to have this effect if the actual cost exceeds that specified in the uniform premium table. The technical correction adopted in the bill was intended to give full effect to the prior Congressional intent to discourage discrimination (i.e., when the actual cost may be less than that specified in the uniform premium table).

In addition, the bill revises the definition of key employee to include any former employee if such employee, at the time of separation from service, was a key employee. An employee is a key employee at separation from service if the employee was a key employee for the year in which separation occurs or for any of the 4 preceding years. For purposes of applying the nondiscrimination requirements of the group-term life insurance provisions, the bill also clarifies that, to the extent provided in regulations, coverage and benefit tests are applied separately to active and former employees.

The bill also makes a clerical correction to section 83(e)(5), which coordinates that section with section 79. Section 83(e)(5) presently excepts the cost of group-term life insurance to which section 79 applies from the application of section 83 (governing the taxation of property transferred in connection with the performance of services). The bill provides that section 83 shall not apply to group-term life insurance covered by section 79. Thus, when an employee retires, the present value of any future group-term life insurance coverage which may become nonforfeitable upon retirement (or the value of an amount set aside by an employer to fund such coverage) will not be taxed immediately to the employee upon retirement. Rather, if the coverage constitutes group-term life insurance within the meaning of section 79 (e.g., the employee does not receive a permanent guarantee of life insurance coverage from the insurance company), the cost of the coverage will be taxable annually to the retired employee under section 79. This rule also applies in the case of an employee who separates from service with a vested right to continuing group-term life insurance coverage.

Finally, the bill clarifies the effective date of the present-law provisions which were adopted in DEFRA by providing that the extension of the $50,000 cap to retired employees and the extension of the nondiscrimination provisions to former employees do not apply to any group-term life insurance plan of the employer in existence on January 1, 1984, but only with respect to an individual who attained age 55 on or before January 1, 1984, and was employed by such employer (or a predecessor employer) at any time during 1983. The DEFRA amendments also shall not apply to any employee who retired from employment on or before January 1, 1984, and who, when he retired, was covered by a group-term life insurance plan of the employer (or a predecessor plan).

The bill amends the rules with respect to grandfathered individuals to provide that, in applying the nondiscrimination rules under section 79, such individuals may be disregarded at the employer's election.

The provision relating to the determination of costs with respect to key employees in a discriminatory plan is effective for taxable years ending after the date of enactment of the bill.

The bill clarifies what qualifies as a comparable successor plan for purposes of the grandfather provision under DEFRA. A comparable successor plan includes, with respect to a grandfathered individual, any plan that does not provide increased benefits. If the benefits of a grandfathered individual are increased, the grandfather rule no longer applies to that individual.

31. Amendment related to certain exchanges of insurance policies (sec. 1828 of the bill and sec. 1035(b) of the Code)

Present Law

Under present law, no gain or loss is recognized on the exchange of (1) a contract of life insurance for another contract of life insurance or for an endowment or an annuity contract; (2) a contract of endowment insurance for another contract of endowment with the same or earlier payment date, or for an annuity contract; or (3) an annuity contract for an annuity contract. For purposes of this exchange rule, an endowment contract and a life insurance contract are defined to include contracts issued by any insurance company taxable under subchapter L of the Code. This change in law effective in 1984 was intended to recognize that the focus of the exchange rule should be on the character and benefits of the contract rather than the particular tax status of the company issuing the contract.

Explanation of Provision

The bill amends the definition of an endowment contract and a life insurance contract by merely requiring that the contracts be issued by any insurance company, whether or not such company is a taxable entity under the Code. This provision applies to exchanges occurring before, on, or after the date of enactment of the technical corrections provision.

32. Waiver of interest on certain underpayments of tax (sec. 1829 of the bill)

Present Law

Interest on an underpayment of tax generally is payable from the due date of the return (determined without regard to extensions).

Explanation of Provision

The bill provides that no interest shall be payable for any period before July 19, 1984, on any underpayment of tax imposed by the Internal Revenue Code, to the extent such underpayment was created or increased by any provision of subtitle A of title II of the Tax Reform Act of 1984.

C. Technical Corrections to Private Foundation Provisions

1. Reduction in section 4940 excise tax where charitable payout meets certain distribution requirements (sec. 1832 of the bill and sec. 4940 of the Code)

Present Law

Under section 303 of the Act, the rate of the excise tax imposed on the net investment income of a private foundation (Code sec. 4940) is reduced for a taxable year from two percent to one percent if the amount of qualifying distributions made by the foundation

during that taxable year equals or exceeds the sum of (1) an amount equal to the foundation's assets for such taxable year multiplied by the average percentage payout for the base period, plus (2) one percent of the foundation's net investment income for such taxable year. However, the reduction is not available for a year if the foundation's average percentage payout for the base period is less than five percent, or 3-1/3 percent in the case of a private operating foundation (Code sec. 4940(e)(2)(B)). The reduction in the section 4940 tax rate is effective for taxable years beginning after 1984.

Explanation of Provision

The bill modifies the rule disqualifying certain foundations from the section 4940 rate reduction, to provide that the rate reduction is not available if the foundation was liable for tax under section 4942 with respect to any year in the base period.

This modification effectuates the intended rule that a foundation which failed in any base period year to make the minimum required expenditures for charitable purposes should not be eligible to obtain the benefit of tax reduction merely by increasing its qualifying distributions (in an amount at least equal to one percent of net investment income) up to the minimum section 4942 level. As a result of the modification made by the bill, a nonoperating foundation will not be disqualified from the rate reduction in two situations where the foundation does not incur liability for section 4942 taxes even though the amount of its qualifying distributions (sec. 4942(g)) does not equal at least five percent of its assets. The first situation results from the fact that under section 4942(d), the distributable amount equals the minimum investment return (five percent of assets) reduced by the sum of any taxes imposed on the foundation for the taxable year under section 4940 and the unrelated business income tax. The second situation results from the fact that under section 4942(i), the distributable amount is further reduced by the amount of any excess distributions carryovers from a prior year. However, since neither the amount of such taxes nor the amount of such carryover distributions is included in the definition of qualifying distributions in section 4942(g), a foundation whose distributable amount is reduced by such taxes or carryover excess distributions does not incur section 4942 tax liability if the amount of its qualifying distributions, while less than the minimum investment return, equals or exceeds the distributable amount as thus computed. At the same time, the technical amendment made by the bill precludes any reduction in the section 4940 tax if, with respect to any base period year, the foundation is liable for tax under section 4942 for failure to satisfy the minimum distribution requirements.

2. Exemption for certain games of chance (sec. 1833 of the bill and sec. 513 of the Code)

Present Law

Section 311 of the Act provides that, for purposes of Code section 513, the term unrelated trade or business does not include any

trade or business that consists of conducting a game of chance if (1) the game of chance is conducted by a nonprofit organization, (2) the conducting of the game by such organization does not violate any State or local law, and (3) as of October 5, 1983, there was a State law in effect that permitted the conducting of the game of chance only by a nonprofit organization (i.e., the conducting of the game of chance by other than nonprofit organizations would violate the State law). This provision applies to games of chance conducted after June 30, 1981.

Explanation of Provision

The bill clarifies that the only State law to which the provision is intended to apply is a North Dakota law originally enacted on April 22, 1977.

D. Technical Corrections to Tax Simplification Provisions (secs. 1841–1848 of the bill)

Present Law

The Act contained a title which added a number of provisions intended to simplify and improve the laws. These included provisions related to the individual estimated tax, domestic relations, at-risk, administrative provisions, distilled spirits, the Tax Court, income tax credits and deadwood.

Explanation of Provisions

The bill makes numerous nonsubstantive clerical and conforming amendments to these provisions.

The bill restores two provisions of prior law which were inadvertently changed by the Act. First, certain non-resident aliens will continue to be required to make estimated tax payments in three, rather than four, installments. One-half of the estimated tax will be due with the first payment. Second, the principles of prior law relating to the carryover of credits (including the foreign tax credit) by taxpayers subject to the alternative minimum tax are restored. The conforming amendment relating to the foreign tax credit will apply to taxable years beginning after December 31, 1982 (the effective date of the changes to the minimum tax made by TEFRA).

The bill also amends the domestic relation provisions to provide that alimony payments under certain support decrees (described in section 71(b)(2)(C)) will not be disqualified solely because the decree does not specifically state that the payments will terminate at the payee's death. In addition, the bill clarifies that in the case of the transfer of property to a trust for the assumption of (or subject to) liabilities in excess of basis, gain will be recognized to the extent of such excess notwithstanding section 1041(a). Gain will also be recognized on the transfer of installment obligations to a trust.

E. Technical Corrections to Employee Benefit Provisions

1. Funded Welfare Benefit Plans (sec. 1851 of the bill and secs. 419, 419A, 505, 512, and 4976 of the Code)

Under present law, the amount of the deduction otherwise allowable to an employer for a contribution to a welfare benefit fund for any taxable year is not to exceed the qualified cost of the fund for the year. The qualified cost of a welfare benefit fund for a year is the sum of (1) the qualified direct cost of the fund for the year and (2) the addition (within limits) to reserves under the fund for the year (the qualified asset account), reduced by the after-tax income

of the fund. The deduction limits do not apply to a 10-or-more employer plan.

a. Definition of fund

Present Law

Under present law, a fund is defined as any tax-exempt social club, voluntary employees' beneficiary association (VERA), supplemental unemployment compensation benefit trust (SUB), or group legal services organization; any trust corporation, or other organization not exempt from income tax; and, to the extent provided by Treasury regulations, any account held for an employer by any person. A fund includes a retired life reserve account maintained by an insurance company on behalf of an employer. Further, if an employer contributes amounts to an insurance company for benefits and under that arragement the employer is entitled to a rebate if the amount paid exceeds benefit claims or is liable if the benefit claims exceed the amount paid, then such contributions are considered to have been made to a welfare benefit fund.

Finally, under present law, an employer is not permitted a deduction for premiums paid on a life insurance policy covering the life of any officer or employee, or of any person financially interested in any trade or business carried on by the employer, if the employer is directly or indirectly a beneficiary of the policy (sec. 264(a)(1)).

Explanation of Provision

The bill amends the definition of a "fund" to exclude amounts held under the following types of insurance arrangements: (1) an insurance contract subject to sec. 264(a)(1); and (2) certain "qualified nonguaranteed contracts."

First, under the bill, the term "fund" would not include amounts held by an insurance company pursuant to a life insurance policy on the life of an officer, employee, or person financially interested in the trade or business of the employer, if the employer is the direct or indirect beneficiary of the policy because the amounts contributed are not deductible by the employer.

The bill also modifies the term "fund" to exclude amounts held by an insurance company under certain "qualified, nonguaranteed contracts." A qualified, nonguaranteed contract is defined under the bill as an insurance contact (including a reasonable premium stabilization reserve) to the extent that (1) there is no guarantee of a renewal of the contract, and (2) the amounts payable to the employer or employees as experience-rated refunds or policy dividends are not guaranteed and are substantially unrelated (directly or indirectly) to the amount of welfare benefits paid to (or on behalf of) the employees of the employer or their beneficiaries, the administrative expenses incurred by (or on behalf of) the insurance company in providing welfare benefits to (or on behalf of) the employees of the employer, and the investment experience of the insurance company on amounts contributed by or held for the employer. Thus, under the bill, amounts that are held by an insurance company for an employer generally are not to be treated as a fund to

the extent that the amounts are subject to a significant current risk of economic loss based substantially on factors other than the amount of welfare benefits, administrative expenses, and investment return relating to the employer.

Finally, the committee intends that the definition of a qualified, nonguaranteed insurance contract does not include amounts held by an insurance company pursuant to certain guaranteed renewal contracts, under which the employer's right to renew the contract is guaranteed, but the level of premiums charged to the employer is not guaranteed. The committee believes that, if the insurance company can increase premiums charged to an employer to the point at which the contract is no longer feasible for the employer, the contract should not be treated as a guaranteed renewal contract.

In addition, the bill provides that even an arrangement that satisfies the definition of a qualified, nonguaranteed insurance contract will not be excluded from treatment as a fund, unless the amount of any experience rated refund or policy dividend payable with respect to a policy year is treated by the employer as paid or accrued in the taxable year in which the employer's contributions for the policy year were deductible. If the actual amount of the refund or dividend is not known by the due date of the employer's tax return for the year, Treasury regulations could permit the use of a reasonable estimate of the amount of such refund or dividend. In addition, Treasury regulations could require insurance companies to submit information (including proprietary information of the insurance company) relating to the basis for the calculation of experience refunds and policy dividends.

To the extent that the general rules for the exclusion of amounts held by an insurance company are satisfied, amounts held by an insurance company for a reasonable premium stabilization reserve for an employer are not treated as a fund. Thus, a premium stabilization reserve, if limited to a reasonable amount, such as 20 percent of premiums for the year, would not be treated as a fund to the extent that (1) such amounts are subject to a significant current risk of economic loss, and (2) experience rated refunds and policy dividends payable by the reserve with respect to a policy year are treated by the employer as paid or accrued in the taxable year in which the employer's contributions for such policy year were deductible. Solely for purposes of these provisions, the amounts released from a premium stabilization reserve to purchase current insurance coverage are to be treated as experience rated refunds or policy dividends.

Whether amounts are subject to a significant current risk of loss depends upon the facts and circumstances. For example, if an employer does not have a guaranteed right under an insurance contract to policy dividends based solely on the employer's experience but the insurance company has, in practice, consistently paid such dividends based solely on the employer's experience, it is anticipated that Treasury regulations would provide that the amounts held under the contract constitute a fund because they are not subject to a significant current risk of economic loss.

b. Coordination of post-retirement medical benefits with limits on contributions under qualified plans

Present Law

Under the provisions of DEFRA relating to the coordination of net contributions for post-retirement medical benefits with the overall limits on contributions and benefits under qualified pension plans and certain other funded plans deferring compensation (secs. 415(c) and (e)), any amount allocated to a separate account for a key employee is treated as an annual addition to a defined contribution plan. Under the overall limits, the annual addition with respect to an employee under all defined contribution plans of an employer for a year is not to exceed the lesser of $30,000 or 25 percent of compensation. A lower limit may apply if the employer also maintains a defined benefit plan for the employee.

Under present law, the 25-percent limit prevents reserve additions for post-retirement medical benefits after the retirement of a key employee. Thus, if an employer made additional contributions to a fund for post-retirement medical benefits on behalf of a retired key employee, then the contribution violates the 25 percent of compensation limit because a retired employee has no compensation.

Explanation of Provision

The bill provides that the amount treated as an annual addition under the rules for coordinating the post-retirement medical benefits with the overall limits on qualified plans is not subject to the 25-percent-of-compensation limit usually applicable to annual additions. For example, assume the compensation of an employee is $100,000 for a year and $5,000 is treated as an annual addition under the limits for the employee under the rules for post-retirement medical benefits under a qualified plan. Assume further that the employee's annual addition for the year under a qualified defined contribution plan, without regard to the post-retirement medical benefit, is $25,000 (a contribution equal to the maximum percentage of compensation limit). Under the bill, the total annual addition for post-retirement medical benefits does not cause the annual addition to exceed the 25-percent limit on annual additions even though the annual addition would exceed that limit if the amount added for post-retirement medical benefits were taken into account. The annual addition of $30,000 would, however, be subject to the separate dollar limit of section 415(c) for the year and, if the employer also maintains a defined benefit plan for the employee, the full annual addition of $30,000 would be taken into account in determining whether the combined plan limits of section 415(e) are satisfied.

The effect of this rule also is to permit the funding of post-retirement medical benefits on behalf of a key employee during periods when the employee has no compensation from the employer (e.g., after retirement).

c. Separate accounting required for certain amounts

Present Law

In order to provide an overall limit with respect to pre-retirement deductions for certain post-retirement benefits of key employees, DEFRA required separate accounting for contributions to provide post-retirement medical or post-retirement life insurance benefits to an individual who is, or ever has been (after the effective date of DEFRA), a key employee.

Explanation of Provision

The bill clarifies the requirement for separate accounting with respect to post-retirement medical benefits and post-retirement life insurance benefits. Under the bill, the requirement does not apply until the first taxable year for which a reserve is computed using the special provisions applicable to these benefits (or assets of a fund held before the effective date are allocated to a separate account). The separate account requirement applies for that first year and for all subsequent taxable years.

d. Reserves for discriminatory post-retirement benefits disregarded

Present Law

Under DEFRA, no reserve is to be taken into account in computing the account limit with respect to a post-retirement medical benefit or a post-retirement life insurance benefit under a plan that does not meet the nondiscrimination standard provided by DEFRA (sec. 505). The application of this rule is unclear both with respect to benefits (such as benefits under a self-insured health plan) that are subject to nondiscrimination requirements different from the DEFRA standard and with respect to benefits (such as benefits under an insured plan) not subject to any nondiscrimination requirement. The nondiscrimination standards of the Act do not apply to benefits under certain collectively bargained plans.

Explanation of Provision

The bill provides that no reserve generally may be taken into account in determining the account limit for a welfare benefit fund for post-retirement medical benefits or life insurance benefits (including death benefits) unless the plan meets the nondiscrimination requirements with respect to those benefits (sec. 505(b)), whether or not those nondiscrimination requirements apply in determining the tax-exempt status of the fund. The bar against taking post-retirement medical benefits and life insurance benefits into account in determining the account limit does not apply, under the bill, in the case of benefits provided pursuant to a collective bargaining agreement between one or more employee representatives and one or more employers if the Secretary of the Treasury finds that the agreement is a collective bargaining agreement and that post-retirement medical benefits or post-retirement life insurance benefits (as the case may be) were the subject of good faith

bargaining between the employee representatives and the employer or employers.

The bill clarifies that certain post-retirement group-term life insurance benefits that fail to satisfy the nondiscrimination requirements of Code section 505(b) may, nevertheless, be taken into account in determining the account limit to the extent that the group-term life insurance benefits are provided under an arrangement with respect to individuals grandfathered under section 223 of the Act.

e. Account limit for life insurance benefits

Present Law

In the case of a life insurance or death benefit, DEFRA provided that the account limit is not to include a reserve to the extent the reserve takes account of an amount of insurance that exceeds the amount that may be provided to an employee tax-free under an employer's group-term life insurance program (sec. 79). In the case of a self-insured death benefit, the account limit is not to include a reserve to the extent that a benefit would be includible in gross income if the limit on excludable death benefits were $50,000.

Explanation of Provision

The bill clarifies that life insurance benefits are not to be taken into account in determining the account limit under a welfare benefit fund to the extent that the aggregate amount of such benefits to be provided with respect to an employee exceeds $50,000. Accordingly, under the bill, the $50,000 limit applies with respect to the aggregate of self-insured and insured life insurance benefits under all funds maintained by the employer. The bill does not change the rules of DEFRA under which certain post-retirement life insurance benefits in excess of $50,000 may be taken into account in determining the account limit for certain individuals under plans in existence on January 1, 1984 (Act sec. 223(d)(2)).

f. Actuarial certification

Present Law

DEFRA provided that the account limit for a qualified asset account (reserve) for a taxable year is generally the amount reasonably and actuarially necessary to fund claims incurred but unpaid (as of the close of the taxable year) for benefits with respect to which the account is maintained and the administrative costs incurred with respect to those claims. Claims incurred but unpaid include claims incurred but unreported as well as claims reported but unpaid. The time at which claims are incurred is the time at which the employee becomes entitled to the benefits, i.e., the time at which the fund becomes liable for the claims. Under DEFRA, insurance premiums, whenever payable, are not regarded as claims incurred but unpaid.

Unless there is an actuarial certification with respect to benefits other than (1) post-retirement medical benefits or post-retirement life insurance benefits or (2) supplemental unemployment compen-

sation (SUB) or severance pay benefits, the account limit for a welfare benefit fund is not to exceed certain safe-harbor limits.

In the case of short-term disability benefits, the safe-harbor limit is 17.5 percent of the qualified direct costs for the immediately preceding year with respect to such benefits. A short-term disability is a disability that has persisted for at least 2 weeks and is not a long-term disability. A long-term disability is a disability that (1) has persisted for at least 5 months, and (2) a medical evaluation determines that such disability is expected to last for at least 12 months.

The legislative history of DEFRA provides that no more than 5 months of benefit payments are to be deemed to have been incurred with respect to short-term disabilities.

Explanation of Provision

The bill provides that the requirement for an actuarial certification also applies to post-retirement medical benefits and post-retirement life insurance benefits, unless a safe harbor computation is used.

The committee clarifies the application of the account limit rules to short-term disability. Because a disability that is expected to last more than 5 months, but less than 12 months, is not treated as a long-term disability, the committee intends that the legislative history of DEFRA will not prohibit the funding of up to 12 months of benefit payments for short-term disabilities that are expected to last more than 5 months.

g. Aggregation of funds

Present Law

In addition to the limits provided by DEFRA with respect to post-retirement medical benefits provided under a welfare benefit fund, DEFRA dollar limits were provided with respect to the amount of life insurance benefits, disability benefits, and supplemental unemployment compensation benefits or severance pay benefits for which a reserve may be accumulated for any participant. DEFRA did not specify that these limits apply to the aggregate of reserves under all funds of an employer rather than on a fund-by-fund basis. Also, in the case of life insurance benefits, DEFRA did not specify that the limit on reserves is to be applied to the aggregate of insured and self-insured benefits.

Explanation of Provision

The bill provides that, in computing the dollar limits applicable to the amount of reserves for disability benefits, post-retirement medical benefits, and post-retirement life insurance benefits for which reserves may be accumulated for any participant, all welfare benefit funds of an employer are treated as a single fund. In the absence of Treasury regulations to the contrary, the limit is allocated proportionately to the amount of the death benefit in each plan.

h. Transition rules

Present Law

The account limit for any of the first four taxable years to which the rules for welfare benefit funds apply is increased by the applicable percentage of any existing excess reserve. In particular, DEFRA provided that, for the first year, the limit is to be the sum of (1) the limit determined without regard to the transitional rule, and (2) 80 percent of the existing excess reserve amount. For the second, third, and fourth succeeding years, 60, 40, and 20 percent, respectively, is substituted for 80 percent. DEFRA did not clearly provide that the existing excess reserve for any year is to be the excess of (1) the amount of assets set aside to provide disability, medical, SUB, severance pay, or life insurance benefits under a plan and fund to provide a benefit in existence on July 18, 1984, as of the close of the first taxable year ending after that date, over (2) the account limit determined, for the year the computation is being made, without regard to the transitional rule.

Explanation of Provision

The bill provides that, under the transition rules for existing excess reserves, the amount of existing excess reserves for any year is the excess (if any) of (1) the amount of assets set aside at the close of the first taxable year ending after July 18, 1984, to provide disability benefits, medical benefits, SUB or severance pay benefits, or life insurance benefits, over (2) the account limit (without regard to the transition rules) for the taxable year for which the excess is being computed. The bill further provides that the transition rule allowing an increase in the account limit because of existing excess reserves applies only to a welfare benefit fund which, on July 18, 1984, had assets set aside to provide the enumerated benefits.

Accordingly, in the case of an employer that maintains a funded plan which had assets set aside to provide disability benefits, medical benefits, SUB or severance pay benefits, or life insurance benefits on July 18, 1984, and to which the deduction limits first apply for the taxable year beginning January 1, 1986, the increase in the account limit for 1986 attributable to existing excess reserves is 80 percent of the excess, if any, of the amount of assets set aside at the close of 1984 (the first taxable year ending after July 18, 1984) over the account limit determined under the general rules for 1986. For 1987, however, the increase attributable to existing excess reserves is 60 percent of the excess, if any, of the amount of assets set aside at the close of 1984 over the account limit determined for 1987.

i. Tax on unrelated business income

Present Law

Under present law, the tax on unrelated business taxable income of a social club, VEBA, SUB, or group legal service organization applies to an amount equal to the lesser of the income of the fund or the amount by which the assets in the fund exceed a specific limit on amounts set aside for exempt purposes. The limit on the

amount that may be set aside for a year is generally not to increase the total amount that is set aside to an amount in excess of the account limit for the taxable year determined under the deduction limits.

The limitation on the amount that may be set aside for purposes of the unrelated business income tax does not apply to income attributable to certain existing reserves for post-retirement medical or post-retirement life insurance benefits. Under DEFRA, this exclusion applies only to income attributable to the amount of assets set aside, as of the close of the last plan year ending before July 18, 1984, for purposes of providing such benefits.

In addition, DEFRA provided for the inclusion of a similar amount (deemed unrelated income) in the gross income of an employer who maintains a welfare benefit fund that is not exempt from income tax. It is anticipated that Treasury regulations will provide that deemed unrelated income will be treated in a manner that will not subject the same income to tax more than once.

Explanation of Provision

The bill makes it clear that the tax on unrelated business income applies in the case of a 10-or-more employer plan. Under the bill, the account limit is to be determined as if the rules limiting deductions for employer contributions applied.

In addition, the bill provides that the transition rule for pre-existing reserves for post-retirement medical and life insurance benefits applies to the greater of the amount of assets set aside as of (1) July 18, 1984, or (2) the close of the last plan year ending before July 18, 1984, rather than only to assets set aside as of the end of the plan year ending before July 18, 1984.

The bill deletes the provision of the Code barring a set aside for certain assets used in the provision of permissible benefits (facilities). Treasury regulations are to provide that facilities used to provide permissible benefits are disregarded in determining whether fund assets exceed the account limit for a qualified asset account.

In addition, the bill provides that if any amount is included in the gross income of an employer for a taxable year as deemed unrelated income with respect to a welfare benefit fund, then the amount of the income tax imposed on the deemed unrelated income is to be treated as a contribution paid by the employer to the fund on the last day of the taxable year and, thus, is deductible, subject to the limits on deductions for fund contributions. The tax attributable to the deemed unrelated income is to be treated as if it were imposed on the fund for purposes of determining the after-tax income of the fund.

j. Tax on disqualified benefits provided under funded welfare benefit plans

Present Law

Under DEFRA, if a welfare benefit fund (other than an arrangement funded exclusively by employee contributions) provides a disqualified benefit during a taxable year, then an excise tax is im-

posed for that year on each employer who maintains the fund. The tax is equal to 100 percent of the disqualified benefit.

Under DEFRA, a disqualified benefit is (1) any medical benefit or life insurance benefit provided with respect to a key employee other than from a separate account required under the rules limiting employer deductions with respect to welfare benefit funds, (2) any post-retirement medical or life insurance benefit unless the plan meets the requirements of the nondiscrimination rules of DEFRA for benefits under a welfare benefit fund, or (3) any portion of a welfare benefit fund reverting to the benefit of the employer. A portion of a welfare benefit fund is not considered to revert to the benefit of an employer merely because it is applied, in accordance with the plan, to provide welfare benefits to employees or their beneficiaries. Also, amounts returned to employees that represent the employees' contributions to the fund are not treated as amounts reverting to the benefit of the employer and, therefore, are not subject to the tax on disqualified benefits.

Explanation of Provision

With respect to benefits required to be paid from a separate account, the bill defines the term "disqualified benefit" to mean any post-retirement medical benefit or post-retirement life insurance benefit provided with respect to a key employee if a separate account is required to be established for the employee and the payment is not from such an account. Accordingly, pre-retirement benefits would not be considered to be disqualified benefits under the bill merely because they are paid to a key employee from a source other than a separate account.

In addition, under the bill, a post-retirement medical benefit or post-retirement life insurance benefit provided by a fund with respect to an individual in whose favor discrimination is prohibited is a disqualified benefit unless the plan meets the nondiscrimination requirements of DEFRA with respect to the benefit (sec. 505(b)), whether or not the nondiscrimination requirements apply in determining the tax-exempt status of the fund from which the benefit is provided.

Under the bill, if a plan is not exempt from the nondiscrimination rules under the rules for collectively bargained plans, a discriminatory benefit is a disqualified benefit subject to the excise tax even though no discrimination test applies for purposes of determining the exempt status of the fund from which the benefit is provided. A benefit is not subject to the nondiscrimination requirements if it is provided under a plan maintained pursuant to a collective bargaining agreement between one or more employee representatives and one or more employers if the Secretary of the Treasury finds that the agreement is a collective bargaining agreement and that post-retirement medical benefits or post-retirement life insurance benefits (as the case may be) were the subject of good faith bargaining between the employee representatives and the employer or employers.

Further, under the bill, a payment that reverts to the benefit of an employer is not a disqualified benefit to the extent it is attributable to an employer contribution with respect to which no deduc-

tion is allowable in the current or any preceding taxable year or to an employee contribution. As under current law, the excise tax on disqualified benefits is inapplicable to welfare benefit contributions funded solely by employees. A reduction is to be made to the amount treated as a carryover (sec. 419(d)) to the extent that any nondeducted contribution reverts to the benefit of an employer. Any amounts reverting to the benefit of an employer are treated as coming first out of nondeducted contributions for purposes of this rule.

Also, the bill provides that a benefit that would otherwise be a disqualified benefit because it does not meet the separate-account rule or because it is discriminatory is not a disqualified benefit if it is a post-retirement benefit that is charged against an existing reserve (or against any income properly allocable to an existing excess reserve) for post-retirement medical or post-retirement life insurance benefits as provided under the transition rules of DEFRA (sec. 512(a)(3)) applicable to the unrelated business income tax.

k. Application of account limits to collectively bargained plans

Present Law

DEFRA provided that, by July 1, 1985, the Secretary of the Treasury was to publish regulations establishing special reserve limit principles with respect to funded welfare benefit plans maintained pursuant to a collective bargaining agreement. In establishing these limits, the Treasury is to presume that reserves in such plans are not excessive because of the arm's-length negotiations between adversary parties inherent in the collective bargaining process. Further, because contributions under collectively bargained plans are often fixed over a multiyear period on the basis of economic assumptions that may be inaccurate and because such contributions may be the only source of benefits to be provided during layoffs, strikes, lockouts, and economic recession, these special limits are to allow substantial flexibility with respect to the account limits.

On July 1, 1985, Treasury regulations were not published relating to the special account limits for collectively bargained plans. These regulations provide that the account limits under the normal rules for welfare benefit funds do not apply to collectively bargained funds until a specified period of time after the issuance of regulations specifying the higher limits applicable to such collectively bargained funds. Thus, pending the issuance of such regulations, employer contributions to a collectively bargained fund are deductible (without limit) and earnings on fund assets are tax exempt.

Explanation of Provision

The bill permanently exempts collectively bargained VEBAs from the account limits applicable to welfare benefit funds without regard to any Treasury regulations providing special account limits for such funds. Thus, employer contributions to such VEBAs are deductible and earnings on assets of such VEBAs are tax exempt.

l. Application of account limits to welfare benefit plans funded solely with employee contributions

Present Law

Under present law, the account limits for welfare benefit funds apply whether a plan is funded with employer or employee contributions. In the case of a plan funded solely by employee contributions, the primary effect of the account limits is to treat earnings on plan assets in excess of the account limits as unrelated business taxable income.

Explanation of Provision

The bill exempts certain VEBAs funded solely with employee contributions from the account limits applicable to welfare benefit funds. This exemption is available only if (1) the VEBA covers at least 50 employees, and (2) other than current insurance protection, the only amounts payable to employees as experience-rated refunds or policy dividends are not guaranteed and are determined by factors other than the amount of welfare benefits paid to (or on behalf of) the employee or the employee's beneficiaries, the administrative expenses of providing such benefits, or the investment experience of such employee contributions (and earnings thereto). Thus, in order for the exemption to apply, the amounts contributed by an employee are required to be subject to a significant risk of current economic loss.

m. Effective dates

Present Law

DEFRA provided that the new limits on deductions under welfare benefit funds generally apply to contributions paid or accrued after December 31, 1985, in taxable years ending after that date. Special effective dates were provided for contributions with respect to facilities and for certain collectively bargained plans. The effective dates for the provisions relating to the tax on unrelated business income and the excise tax on disqualified benefits were unclear under DEFRA.

A transition rule for existing excess reserves is provided with respect to the account limit for any of the first four years to which the rules for welfare benefit funds apply. The existing excess reserve for any year is the excess of (1) the amount of assets set aside to provide disability, medical, SUB, severance pay, or life insurance benefits under a plan and fund to provide such a benefit in existence on July 18, 1984, as of the close of the first taxable year ending after that date, over (2) the account limit determined, for the year for which the computation is being made, without regard to the transitional rule.

Explanation of Provision

The bill provides that the rules of DEFRA relating to the tax on disqualified benefits generally apply to benefits provided after December 31, 1985. Under the bill, however, the tax on disqualified

benefits does not apply to benefits charged against an existing reserve for post-retirement medical benefits or post-retirement life insurance benefits (as defined under the transition rules (sec. 512(a)(3))) applicable to the unrelated business income tax.

The bill clarifies that the amendments made by the Act with respect to the tax on unrelated business income are effective for taxable years ending after December 31, 1985, and are to be treated as a change in the rate of income tax imposed for purposes of Code section 15.

Further, the committee intends that the transition rule for existing excess reserves first applies to the first taxable year for which DEFRA is effective. Thus, the phaseout of existing excess reserves does not apply to any taxable year of the fund before the first taxable year to which the DEFRA applies.

2. Treatment of Deferred Compensation Arrangements and Deferred Benefits (sec. 1851(b) of the bill and sec. 512 of the Act)

a. Transition rule for certain taxpayers with fuily vested vacation pay plans

Present Law

Under present law, any plan, method, or arrangement providing for deferred benefits for employees, their spouses, or their dependents is treated as a plan deferring the receipt of compensation (deferred benefit plan). DEFRA provided that a deferred benefit plan includes an extended vacation pay plan, i.e., a plan under which employees gradually, over a period of years, earn the right to additional vacation that cannot be taken until the end of the period. Similarly, a vacation pay plan under which employees can delay the vacation (and also the income inclusion) beyond the current taxable year is a deferred benefit plan. However, any vacation benefit to which an election applies under section 463 (relating to accrual of vacation pay) is not considered a deferred benefit.

The provision of DEFRA was effective for amounts paid or incurred after July 18, 1984, in taxable years ending after that date.

Explanation of Provision

The bill provides a transition rule in the case of a fully vested vacation pay plan in which payments are required within one year after the accrual of the vacation (and are, in fact, paid). If the taxpayer makes an election under section 463 for the taxpayer's first taxable year ending after July 18, 1984, then, in lieu of establishing a suspense account under section 463, the election is treated as a change in the taxpayer's method of accounting and the adjustments required under section 481 are taken into account.

Under the bill, the time for making a section 463 election is extended to six months after the date of enactment in the case of a taxpayer otherwise eligible for the transition rule.

b. Clarification of the scope of the deduction-timing rules applicable to deferred compensation arrangements

Present Law

Under present law, an arrangement for compensation or benefits having the effect of a plan or method deferring the receipt of compensation is subject to the deduction-timing rules applicable to deferred compensation plans (sec. 404(a)(5)). In order to be subject to the deduction rules of section 404(a), a plan or method deferring compensation must satisfy the conditions for deductibility under section 162 (relating to trade or business expenses) or section 212 (relating to expenses for production of income).

Explanation of Provision

The bill clarifies that the deduction-timing rules for deferred compensation arrangements apply to any plan or method of deferring compensation regardless of the section under which the amounts might otherwise be deductible and that the amounts shall be deductible under section 404(a)(5) and shall not otherwise be deductible under any other section. This clarification is necessary to prevent taxpayers from asserting that deferred compensation is attributable to capitalizable compensation expenses and, thereby, accelerate the timing of the deduction for such deferred compensation. Further, this clarification conforms the treatment of deferred compensation with the treatment of losses, expenses, and interest with respect to transactions between related taxpayers (as amended by DEFRA).

3. Qualified Pension, Profit-Sharing, and Stock Bonus Plans

a. Distribution rules for qualified plans (secs. 1852(a) and (b) of the bill and secs. 72, 401, 402, 403, and 408 of the Code)

Present Law

Distributions prior to age 59½

Prior to DEFRA, the Code imposed an additional 10-percent income tax on distributions made to key employees in a top-heavy plan prior to age 59½, death, or disability unless the participant died or became disabled. DEFRA provided that the additional tax applies to 5-percent owners (rather than key employees), but only to the extent that the distribution is attributable to contributions made or benefits accruing in years in which the participant was a 5-percent owner (as defined in sec. 416(i)).

Before-death distribution rules

DEFRA amended the minimum distribution rules to provide that a trust is not a qualified trust unless the plan of which it is a part provides that the entire interest of the employee will be distributed no later than the required beginning date. Alternatively, the requirements of DEFRA may be satisfied if the entire interest is to be distributed (in accordance with Treasury regulations), beginning no later than the required beginning date, over (1) the life of the

employee, (2) the lives of the employee and a designated beneficiary, (3) a period (which may be a term certain) not extending beyond the life expectancy of the employee, or (4) a period (which may be a term certain) not extending beyond the life expectancies of the employee and a designated beneficiary.

Under present law, the required beginning date is generally April 1 of the calendar year following the calendar year in which (1) the employee attains age 70½ or (2) the employee retires, whichever is later. If an employee is a 5-percent owner (as defined at sec. 416(i)) with respect to the plan year ending in the calendar year in which the employee attains age 70½, then the required beginning date is generally April 1 of the calendar year following the calendar year in which the employee attains age 70½, even though the employee has not retired. DEFRA did not, however, require the distribution to a 5-percent owner of employer securities subject to the 84-month holding period of section 409(d) before the expiration of the 84-month period.

Benefits provided under a qualified plan must be for the primary benefit of an employee, rather than the employee's beneficiaries. Accordingly, any death benefits provided for a participant's beneficiaries must be incidental.[13] Under this incidental death benefit rule, a qualified plan generally is required to provide for a form of distribution under which the present value of the retirement benefit payments projected to be made to the participant, while living, is more than 50 percent of the present value of the total payments projected to be made to the participant and the participant's beneficiaries. The incidental death benefit rule is designed to limit the use of qualified plans for nonretirement purposes (e.g., to provide for deferral of income tax or to provide for tax-favored transfers of wealth).

The before-death distribution rules under present law for IRAs are similar to the before-death distribution rules provided for qualified plans and are applied separately to each IRA owned by an individual.

After-death distribution rules

DEFRA provided rules that apply in the case of an employee's death before the employee's entire interest has been distributed. Under DEFRA, if distributions have commenced to the employee before death, then the remaining portion of the employee's interest is to be distributed at least as rapidly as under the method of distribution in effect prior to death. If distributions have not commenced before the participant's death, DEFRA provided permissible periods over which the remaining interest may be paid to a designated beneficiary. A plan may allow a beneficiary to accelerate payments of the remaining interest.

Similar rules are provided for after-death distributions from or under an individual retirement account or annuity. In addition, the rules applicable to after-death distributions under an annuity contract apply to a custodial account that is treated as a tax-sheltered annuity contract (sec. 403(b)(7)). Other tax-sheltered annuity con-

[13] See, e.g., Rev. Rul. 72-241, 1972-1 C.B. 108.

tracts are subject to the after-death distribution rules applicable to annuity contracts (sec. 72(s)).

Qualifying rollover distributions

Under DEFRA, distributions of less than the balance to the credit of an employee under a qualified plan or a tax-sheltered annuity contract may be rolled over, tax-free, by the employee (or the surviving spouse of the employee) to an IRA. A rollover of a partial distribution is permitted only if (1) the distribution equals at least 50 percent of the balance to the credit of the employee, determined immediately before the distribution, (2) the distribution is not one of a series of periodic payments, and (3) the employee elects tax-free rollover treatment at the time and in the manner prescribed by the Secretary of the Treasury.

Explanation of Provisions

Distributions prior to age 59½

Under the bill, the 10-percent additional income tax on distributions prior to age 59½, death, or disability (within the meaning of sec. 72(m)(7)) is applied to amounts received from or under a qualified plan by a 5-percent owner. However, the bill provides that the tax does not apply to benefits accrued before January 1, 1985. In applying the rule, the bill provides that distributions will be deemed to be made first out of benefits accrued before January 1, 1985.

The bill removes the requirement of present law that each plan distribution must be examined to determine whether it is attributable to contributions made on behalf of a participant while the participant was a 5-percent owner. Instead, the bill provides that the status of an individual at the time of a plan distribution is the relevant factor for imposition of the tax.

The bill defines a 5-percent owner as any individual who at any time during the 5 plan years preceding the plan year in which the distribution is made was a 5-percent owner (within the meaning of sec. 416(i)(1)(B)).

Before-death and after-death distribution rules

The bill clarifies the required beginning date for distributions from or under qualified plans and IRAs. As noted above, under current law, in the case of a 5-percent owner, distributions from a qualified plan must commence no later than April 1 of the calendar year following the year in which the 5-percent owner attains age 70½. The bill clarifies that an individual is considered to be a 5-percent owner for a calendar year if the individual was a 5-percent owner (within the meaning of section 416(i)(1)(B)) at any time during the plan year ending in the calendar year in which the individual attains age 70½, or during any of the four preceding plan years. The bill also clarifies that if an employee becomes a 5-percent owner in a plan year subsequent to the plan year ending in the calendar year in which the employee attained age 70½, the required beginning date is April 1 of the calendar year following the calendar year in which ends the plan year that the employee becomes a 5-percent owner.

The bill clarifies that distributions from IRAs are to commence no later than April 1 of the calendar year following the year in which the owner of the IRA attains age 70½, without regard to whether the owner has retired. In addition, the bill clarifies that distributions from IRAs are subject to the incidental death benefit rules applicable to qualified plans.

The bill repeals the exception to the required distribution rules applicable to amounts held by an ESOP, which are subject to the 84-month rule of Code Section 409(a). Instead, the bill provides an exception to the 84-month rule for amounts required to be distributed under the required distribution rules for qualified plans.

Further, the bill provides that amounts required to be distributed from a qualified plan or IRA under the required distribution rules are not eligible for rollover treatment. This rule ensures that an individual will not be able to circumvent the required distribution rules by taking a required distribution at year's end and rolling over that distribution before or after the beginning of the next year. This restriction would apply only to the amounts required to be distributed. Thus, individuals would not be prevented from rolling over those distributions that (1) exceed the minimum required distribution, or (2) occur during a year in which no minimum distribution is required. For this purpose, the first amounts distributed to an individual during a taxable year are treated as amounts required to be distributed.

Qualifying rollover distributions

The bill clarifies that the distribution of the entire balance to the credit of an employee in a qualified plan may be treated as a distribution eligible for rollover under the partial distribution rollover rules, so long as such distribution does not constitute a "qualified total distribution." Thus, a total distribution that is not made on account of plan termination, is not eligible for lump sum treatment and does not consist of accumulated deductible employee contributions, would be eligible for rollover under the partial distribution rollover rules.

The bill clarifies that accumulated deductible employee contributions (within the meaning of sec. 72(o)(5)) are not taken into account for purposes of calculating the balance to the credit of an employee under the partial distribution rollover rules. In addition, the bill clarifies that a self-employed individual is generally treated as an employee for purposes of the rules governing the tax treatment of distributions, including the rules relating to rollover distributions.

The bill provides that the rules relating to rollovers in the case of a surviving spouse of an employee who received distributions after the employee's death apply to permit rollovers to an IRA but not to another qualified plan. Also, the bill clarifies that partial distributions are to be rolled over within 60 days of the distribution to be eligible for rollover under the partial distribution rollover rules.

b. Treatment of distributions if substantially all contributions are employee contributions (sec. 1852(c) of the bill and sec. 72 of the Code)

Present Law

Under DEFRA, if substantially all of the contributions under a qualified plan are employee contributions, then distributions under the plan will be considered to be income until all income has been distributed. In addition, if an employee received (directly or indirectly) any amount as a loan under the plan, DEFRA treats the amount of the loan as an amount distributed from the plan.

Under present law, a plan in which substantially all of the contributions are employee contributions is defined as a plan with respect to which 85 percent of the total contributions during a representative period (such as 5 years) as determined under Treasury regulations are employee contributions (whether or not mandatory).

Explanation of Provision

Under the bill, a plan is defined as one in which substantially all of the contributions are employee contributions if 85 percent or more of the total contributions during a representative period are employee contributions. Also, the bill provides that the 5-percent additional income tax on premature distributions from annuity contracts does not apply to distributions from a plan substantially all of the contributions of which are derived from employee contributions.

The bill clarifies that deductible employee contributions are not taken into account as employee contributions for purposes of testing whether 85 percent or more of the total contributions to a plan during a representative period are employee contributions.

c. Provisions relating to top-heavy plans (sec. 1852(d) of the bill and sec. 416 of the Code)

Present Law

Additional qualification standards are provided with respect to a qualified plan that is top-heavy. These rules are designed to provide safeguards for rank-and-file employees and to curb abuse of the special tax incentives available under qualified plans. These rules (1) limit the amount of a participant's compensation that may be taken into account; (2) require accelerated vesting; (3) provide minimum nonintegrated benefits or contributions for plan participants who are not key employees; and (4) reduce the overall limit on contributions and benefits for certain key employees.

A qualified plan is top heavy if, as of the determination date, more than 60 percent of the value of cumulative accrued benefits under the plan is allocable to key employees. Under DEFRA, the cumulative accrued benefits of any individual who has not received any compensation from any employer maintaining a plan during a period of 5 plan years ending on the determination date may be disregarded for purposes of determining whether the plan is top heavy.

DEFRA provided that the additional standards for top-heavy plans do not apply to a governmental plan (as defined in sec. 414(d)), but did not clarify whether State or local government employees may be considered key employees for purposes of other nondiscrimination provisions (e.g., sec. 79).

Explanation of Provision

The bill amends the definition of a key employee to exclude any individual who is an officer or employee of an entity described in section 414(d) (relating to governmental plans). The effect of this provision is to clarify that certain separate accounting and nondiscrimination provisions of the Code (e.g., secs. 79, 415(l), and 419A) do not apply to employees of a State or local government or certain other governmental entities. The bill does not repeal the provision that exempts governmental plans from the top-heavy plan requirements.

The bill also provides that the rule disregarding benefits of an employee after 5 plan years applies to employees who have not performed services for the employer maintaining the plan at any time during the 5-year period ending on the determination date. This provision is added to relieve the administrative difficulties associated with determining whether or not amounts an individual might receive after separation from service are in the nature of compensation.

d. Provisions relating to estate and gift taxes with respect to qualified plan benefits (sec. 1852(e) of the bill and secs. 2039 and 2517 of the Code)

Present Law

Under present law, if the spouse of an employee on whose behalf contributions or payments are made to a qualified plan or a tax-sheltered annuity predeceases the spouse, the decedent spouse's estate does not include any community property interest in the employee spouse's interest in the employer-derived benefits under the qualified plan. A similar rule applies for purposes of the effect of certain transfers under the gift tax provisions.

DEFRA repealed a separate $100,000 limit on the estate tax exclusion (prior to TEFRA, the exclusion had been unlimited) for retirement benefits under qualified plans, tax-sheltered annuities, IRAs, and certain military retirement plans. Under DEFRA, a grandfather rule applied to both the repeal of the exclusion and the reduction of the exclusion to $100,000 in TEFRA. This grandfather rule applied to any decedent (1) whose benefit was in pay status before December 31, 1984 (December 31, 1982, in the case of the TEFRA grandfather) and (2) who, prior to July 18, 1984, had made an irrevocable election to designate the form of the retirement benefit distribution (including the form of any survivor benefit).

In addition, present law provides that the exercise or nonexercise by an employee of an election or option under which an annuity will become payable to a beneficiary under a qualified plan, a tax-sheltered annuity, an IRA, or certain military pensions is not con-

sidered a transfer for purposes of application of the gift tax provisions.

Explanation of Provision

Under the bill, the special community property rules applicable to qualified plans for purposes of the estate and gift tax provisions are repealed. However, the bill clarifies that, if a transfer is made to an employee spouse by a nonemployee spouse in a community property state, the amount transferred is eligible for the unlimited marital deduction (secs. 2056 and 2523).

The bill also repeals the general exemption from the gift tax provisions of transfers pursuant to the exercise or nonexercise by an employee of an election or option under a qualified plan, etc.

The bill modifies the grandfather rules applicable to the repeal of the estate tax exclusion under DEFRA (and the reduction of the exclusion under TEFRA) to provide that, as long as the other conditions for the grandfather are satisfied, an election is deemed to be irrevocable under a qualified plan (but not under an IRA) if the form of the benefit distribution elected is not changed prior to death.

Effective Date

The provision of the bill relating to the repeal of the special rules for community property applies to gifts made or decedents dying after the date of enactment.

e. Affiliated service groups and employee leasing arrangements (sec. 1852(f) of the bill and sec. 414 of the Code)

Present Law

Under DEFRA, the Secretary of the Treasury was granted regulatory authority to develop rules as may be necessary to prevent the avoidance of any employee benefit requirement to which the employee leasing provisions apply through the use of employee leasing or other arrangements (sec. 414(o)).

Explanation of Provision

Under the bill, the special regulatory authority provided to the Secretary of the Treasury with respect to abuses through the use of affiliated service groups (sec. 414(m)(7)) is repealed in favor of the broader general authority provided under the Act (sec. 414(o)). In addition, the bill clarifies that the other definitions relating to affiliated service groups (sec. 414(m)(6)) continue to apply.

f. Discrimination standards applicable to cash or deferred arrangements (sec. 1852(g) of the bill and sec. 401(k) of the Code)

Present law

DEFRA required that all elective deferrals made by a participant under all cash-or-deferred arrangements of an employer be aggregated for purposes of calculating that participant's actual deferral percentage. In addition, a cash-or-deferred arrangement is a quali-

fied cash-or-deferred arrangement only if it meets the special tests provided by the Code relating to actual deferral percentages. If a cash-or-deferred arrangement fails to meet the special tests, an elective deferral made under the arrangement is treated as an employee contribution under the plan which is not excluded from gross income, but the plan of which the arrangement is a part is not to be disqualified if it meets the usual qualification requirements, including the general nondiscrimination rules.

Explanation of Provision

Under the bill, if an employee participates in more than one cash-or-deferred arrangement of an employer, all such cash-or-deferred arrangements are treated as one arrangement for purposes of determining the employee's actual deferral percentage. Thus, an employee's actual deferral percentage taken into account for purposes of applying the special deferral percentage tests under any plan of the employer is the sum of the elective deferrals for that employee under each plan of the employer which provides a cash-or-deferred arrangement, divided by the participant's compensation from the employer.

In addition, the bill clarifies that a plan which includes an otherwise qualified cash-or-deferred arrangement that satisfies the special tests provided by section 401(k)(3) will be treated as satisfying the general nondiscrimination test of section 401(a)(4) with respect to the elective deferrals.

g. Treatment of certain medical, etc., benefits under section 415 (sec. 1852(h) of the bill and sec. 415 of the Code)

Present Law

Under DEFRA, any defined benefit pension plan that provides medical benefits to retired employees is required to create and maintain an individual medical benefit account for any participant who is a 5-percent owner (within the meaning of sec. 416(i)(1)(B)) and to treat contributions allocated to such accounts as annual additions for purposes of the overall limits on contributions and benefits. A similar rule, applicable to post-retirement medical benefits provided through a welfare benefit fund, requires separate accounting for all key employees.

Under the overall limits, the annual addition with respect to an employee under all defined contribution plans of an employer for a year is not to exceed the lesser of $30,000 or 25 percent of compensation. A lower limit may apply if the employer also maintains a defined benefit plan for the employee. The 25-percent limit prevents reserve additions for a retired employee who has no compensation.

Explanation of Provision

The bill clarifies that the special rules for post-retirement medical benefits apply to any pension or annuity plan under which such benefits are provided.

In addition, the bill changes the definition of employees for whom separate accounting is required under a pension plan to con-

form to the definition provided to the separate accounting for post-retirement medical and life insurance benefits under a welfare benefit fund. Thus, separate accounting is required with respect to any employee who is a key employee (within the meaning of section 416(i)).

Further, the bill provides that the amount treated as an annual addition under the rules for coordinating the post-retirement medical benefits with the overall limits on qualified plans is not subject to the 25-percent-of-compensation limit usually applicable to annual additions.

For example, assume the compensation of an employee is $100,000 for a year and $5,000 is treated as an annual addition under the limits for the employee under the rules for post-retirement medical benefits under a qualified plan. Assume further that the annual addition for the year under a qualified defined contribution plan, without regard to the post-retirement medical benefit is $25,000 (a contribution equal to the maximum percentage of compensation limit). Under the bill, the annual addition for post-retirement medical benefits does not cause the annual addition to exceed the 25-percent limit on annual additions, even though the annual addition would exceed that limit if the amount added for post-retirement medical benefits were taken into account. The annual addition of $30,000 would, however, be subject to the separate dollar limit for the year and, if the employer also maintains a defined benefit plan for the employee, the full annual addition of $30,000 would be taken into account in determining whether the combined plan limits are satisfied (sec. 415(e)).

h. Transition rules for effective date of multiemployer pension plan amendments act of 1980

Present Law

The Multiemployer Pension Plan Amendments Act of 1980 (MPPAA) was enacted on September 26, 1980. Under the Employee Retirement Income Security Act of 1974 ("ERISA"), as amended by MPPAA, liability generally was imposed on an employer who withdrew from a multiemployer defined benefit pension plan. The withdrawal liability provisions of the MPPAA generally applied retroactively to withdrawals after April 28, 1980.

The Deficit Reduction Act of 1984 (DEFRA) eliminated the retroactive aspect of MPPAA so that, in general, any liability incurred by an employer under the withdrawal liability provisions of ERISA, as a result of the complete or partial withdrawal from a multiemployer plan before September 26, 1980, is void.

Explanation of Provision

The bill modifies the effective date of the withdrawal liability provisions of MPPAA in two instances. First, in the case of an employer who entered into a collective bargaining agreement that was effective on January 12, 1979, and that remained in effect through May 15, 1982, and under which contributions to a multiemployer plan were to cease on January 12, 1982, the bill changes the effec-

tive date of the withdrawal liability provision of MPPAA from September 26, 1980 to January 12, 1982.

Second, in the case of an employer engaged in the grocery wholesaling business that had ceased all covered operations under the plan before June 30, 1981, and had relocated its operations to a new facility in another State and that meets certain other conditions listed in the bill, the bill modifies the effective date of the withdrawal liability provisions of MPPAA from September 26, 1980 to June 30, 1981.

4. Fringe Benefit Provisions (sec. 1853 of the bill, sec. 531 of the Tax Reform Act of 1984, and secs. 132, 125, and 4977 of the Code)

a. Clarification of line of business requirement

Present Law

Section 132(a)(2) excludes from income certain qualified employee discounts on property or services offered for sale to customers in the ordinary course of the line of business of the employer in which the employee is performing services. For purposes of the discount exclusion, a leased section of a department store is treated as part of the line of business of the person operating the store and employees of the leased section are treated as employees of that person. A leased section of a department store is defined as any part of a department store where over-the-counter sales of property are made and certain other conditions are satisfied.

Explanation of Provision

The bill clarifies that a leased section of a department store which, in connection with the offering of beautician services, customarily makes sales of beauty aids in the ordinary course of business is to be treated as engaged in over-the-counter sales of property, and thus is to be treated as a part of the line of business of the person operating the store. The committee intends that this treatment is to be available without requiring that a specific percentage of the beauty salon's revenue must be earned through the sale of such beauty products because beauty salons have traditionally occupied such leased sections (even though the bulk of their revenue is attributable to performing services rather than selling property.) This is contrasted with businesses (such as insurance companies) that have not traditionally occupied such leased sections.

b. Definition of dependent children

Present Law

Section 531 of DEFRA provided exclusions from gross income for no-additional-cost services and certain other fringe benefits. These exclusions generally apply to benefits provided by an employer for use by an employee, the employee's spouse, or the employee's dependent child. Under the Consolidated Omnibus Budget Reconciliation Act of 1986, use by an employee's parent is also eligible for the exclusion. DEFRA defined the latter term to mean any child of the

employee (1) who is a dependent of the employee, or (2) both of whose parents are deceased (Code sec. 132(f)(2)(B)).

Explanation of Provision

The bill defines dependent child to mean any child of the employee (1) who is a dependent of the employee, or (2) both of whose parents are deceased and who has not attained age 25.

c. Clarification of cross-reference

Present Law

Code section 132(f) provides that for purposes of paragraphs (1) and (2) of subsection (a), any use by the spouse or a dependent child of the employee is treated as use by the employee. The cross-references are to both the no-additional-cost service exclusion (sec. 132(a)(1)), which applies to a service provided by an employer to an employee for use by such employee if certain conditions are met, and the qualified employee discount exclusion (sec. 132(a)(2)), which applies in certain circumstances where the price at which property or services are provided to the employee by the employer is less than the price to nonemployee customers.

Explanation of Provision

To clarify the mechanics of the cross-reference in Code section 132(f), the bill adds the words "for use by such employee" in section 132(a)(2). Accordingly, the qualified employee discount exclusion applies in certain circumstances where the price at which property or services are provided to the employee by the employer for use by such employee (or the spouse or dependent children or parents of the employee) is less than the price to nonemployee customers.

d. Cross-reference in definition of customer

Present Law

Under Code section 132(i), the term "customers" does not include nonemployee customers except for purposes of section 132(c)(2)(B), relating to the determination of gross profit percentage as a limitation on the exclusion for qualified employee discounts.

Explanation of Provision

The bill provides that this exception to the definition of customers also applies for purposes of section 132(c)(2)(A), defining the term "gross profit percentage."

e. Excise tax on certain fringe benefits

Present Law

Under the Act, the line of business limitation otherwise applicable to the section 132 exclusions for no-additional-cost services and qualified employee discounts is relaxed under an elective grandfather rule set forth in section 4977. The requirements for that provi-

sion necessitate determining the employees in certain lines of business of the employer.

Explanation of Provision

The bill clarifies that, in the case of an agricultural cooperative incorporated in 1964, the grandfather rule, requiring that employees in all lines of business of an employer be eligible for employee discounts, is applied without taking into account employees of an employer that became a member of a controlled group including the agricultural cooperative during July of 1980.

f. Applicability of section 132(a)(1) exclusion to certain pre-divestiture retired telephone employees

Present Law

Section 531 of the 1984 Act excludes from income and wages the fair market value of a no-additional-cost service provided by an employer to an employee for use by the employee (Code sec. 132(a)(1)). This exclusion applies if (1) the employer incurs no substantial cost (including foregone revenue) in providing the service; (2) the service is provided by the employer (including certain businesses under common control) or another business with whom the employer has a written reciprocal agreement, and is of the same type ordinarily sold to the public in the line of business in which the employee works; (3) the service is provided to a current or retired employee, or a spouse or dependent child of either, or a widow(er) or dependent children of a deceased employee; and (4) for certain officers, owners, and highly compensated employees, nondiscrimination requirements are met. Subject to certain transitional rules, the exclusion takes effect January 1, 1985.

Generally, situations in which an employer incurs no additional cost in providing services to employees are those in which the employees receive, at no substantial additional cost to the employer, the benefit of excess capacity that otherwise would have remained unused because nonemployee customers would not have purchased it—e.g., where telephone companies provide telephone service to employees within existing capacity. Local telephone service and long-distance telephone service are considered the same line of business.

Explanation of Provision

The provision applies an intended transitional rule under which the fair market value of free telephone service provided to employees of the Bell System who had retired prior to divestiture of the system on January 1, 1984 is excluded from income and wages of such pre-divestiture retired employees. The exclusion pursuant to the provision does not apply to the furnishing of any property or to the furnishing of any type of service that was not furnished to such retirees as of January 1, 1984.

The provision applies in the case of an employee who, prior to January 1, 1984, separated from the service (by reason of retirement or disability) of an entity subject to the modified final judgment (as defined in Code sec. 559(c)(4)). The provision does not

apply to any employee who separated from such service on or after January 1, 1984. No inference is intended from adoption of this transitional rule as to the interpretation of the no-additional-cost service exclusion in any other circumstances.

Under the provision, all entities subject to the modified final judgment are treated as a single employer in the same line of business for purposes of determining whether telephone service provided to the employee is a no-additional-cost service. Also, payment by an entity subject to the modified final judgment of all or part of the cost of local telephone service provided to the employee by a person other than an entity subject to the modified final judgment (including rebate of the amount paid by the employee for the service and payment to the person providing the service) is treated as telephone service provided to the employee by such single employer for purposes of determining whether the telephone service is a no-additional-cost service.

For purposes of this provision, the term "employee" has the meaning given to such term in Code section 132(f). Except as otherwise provided in this provision, the general requirements for the Code section 132(a)(1) exclusion apply; e.g., the exclusion applies to officers, owners, or highly compensated employees only if the no-additional-cost service is available to employees on a nondiscriminatory basis.

g. Cafeteria plans

Present Law

Present law defines a cafeteria plan as a plan under which employees may choose (1) taxable benefits consisting of cash or certain other taxable benefits, or (2) certain fringe benefits that are specifically excluded from gross income by the Code (statutory fringe benefits).

Under the Act, the only taxable benefits which may be offered in a cafeteria plan consist of certain life insurance coverage that is not excludable from gross income, certain vacation pay, or cash. The life insurance coverage that may be offered is the coverage that is included in gross income to the extent the coverage exceeds $50,000 or to the extent it is provided on the life of a spouse or dependent of an employee. Vacation days may be provided under a cafeteria plan only if the plan precludes any participant from using (or receiving cash for) vacation days remaining unused as of the end of the plan year.

A cafeteria plan may offer any fringe benefit (other than scholarships or fellowships, vanpooling, educational assistance, or miscellaneous fringe benefits) that is excludable from gross income under a specific section of the Code.

Under the Act, both general and special transition relief is provided with respect to the Treasury regulations on cafeteria plans, for cafeteria plans and "flexible spending arrangements" in existence on February 10, 1984.

Explanation of Provision

Under the bill, the definition of permissible cafeteria plan benefits is clarified. The effect of the provision, which changes the reference in section 125 from nontaxable benefits to qualified benefits is to (1) eliminate any possible implication that a taxable benefit provided through a cafeteria plan is nontaxable, and (2) clarify that certain taxable benefits, as permitted under Treasury regulations, can be provided in a cafeteria plan.

The bill makes two changes to the transition relief provided to certain cafeteria plans under section 531(b) of the Tax Reform Act of 1984. The first change provides that a cafeteria plan, in existence on February 10, 1984, maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers will be granted relief under the transition rules until the expiration of the last collective bargaining agreement relating to the cafeteria plan. When a collective bargaining agreement terminates is determined without regard to any extension of the agreement agreed to after July 18, 1984. Also, if a cafeteria plan is amended to conform with either the requirements of the Act or the requirements of any cafeteria plan regulations, the amendment is not treated as a termination of the agreement.

Second, the bill provides that a cafeteria plan which suspended a type or amount of benefit after February 10, 1984, and subsequently reactivated the benefit is eligible for transition relief under either the general or special transition relief provision.

h. Clarification of de minimis fringe benefits

Present Law

Under section 132(e), gross income does not include any property or service the fair market value of which is so small that accounting for it is unreasonable or administratively impractical. Included in these de minimis fringe benefits are transit passes provided at discounts not exceeding $15 a month ($180 a year).

Explanation of Provision

The committee clarifies that the de minimis fringe benefit exclusion includes tokens, vouchers, and reimbursements to cover the costs of commuting by public transit, as long as the amount of such reimbursement, etc., provided by the employer does not exceed $15 a month ($180 a year). The value of all such transit benefits (including any discounts on passes) furnished to the same individual are aggregated for purposes of determining whether the $15 limit is reached.

i. Transitional rules for treatment of certain reductions in tuition

Present Law

DEFRA provided an exclusion for qualified tuition reductions provided to an employee of an educational institution for education below the graduate level (sec. 117(d)). Also, the tuition reduction may be provided for the education of the spouse or a dependent child of the employee.

The tuition reduction exclusion is not available to officers, owners, or highly compensated employees if the plan discriminates in favor of such employees.

Explanation of Provision

Under the bill, for purposes of testing whether a tuition reduction program is nondiscriminatory, a special rule applies to a certain plan. A plan is treated as nondiscriminatory if the plan meets the nondiscrimination requirement (as added by the bill) on the day on which eligibility to participate in the plan closed, (2) at all times thereafter, the tuition reductions available under the plan are available on substantially the same terms to all employees eligible to participate in the plan, and (3) the eligibility to participate in the plan closed on June 30, 1972, or December 31, 1975. Of course, the conditions for eligibility cannot be altered after the eligibility closed.

In addition, in the case of an employer who maintains plans to which the special rule applies, employees not included in the plan who are included in a unit of employees covered by an agreement that the Secretary of the Treasury finds to be a collective bargaining agreement between employee representatives and one or more employers, if there is evidence that such benefits were the subject of good faith bargaining are excluded from consideration. For purposes of testing plans not subject to this special rule, employees covered by plans subject to this special rule are disregarded in all respects.

5. Employee Stock Ownership Plans (ESOPs)

a. Sales of stock to employee stock ownership plans or certain cooperatives (sec. 1854(a) of the bill and secs. 1042 and 4978 of the Code)

Present Law

In general

A taxpayer may elect to defer recognition of gain on the sale of certain qualified securities to an employee stock ownership plan (ESOP) or to an eligible worker-owned cooperative (EWOC) to the extent that the taxpayer reinvests the proceeds in qualified replacement property within a replacement period. To be eligible for nonrecognition treatment, (1) the qualified securities must be sold to an ESOP or EWOC; (2) the ESOP or EWOC must own, immediately after the sale, at least 30 percent of the total value of the employer securities then outstanding; (3) the ESOP or EWOC must preclude allocation of assets attributable to qualified securities to certain individuals; and (4) the taxpayer must provide certain information to the Secretary of the Treasury.

Qualified securities; qualified replacement property

For purposes of this provision, qualified securities are defined as employer securities that (1) are issued by a domestic operating corporation that has no readily tradable securities outstanding, (2) have been held by the seller for more than one year, and (3) have

not been received by the seller as a distribution from a qualified plan or as a transfer pursuant to an option or similar right to acquire stock granted to an employee by an employer (other than stock acquired for full consideration).

Qualified replacement property (which includes both debt and equity instruments, as defined in sec. 165(g)(2)) consists of securities issued by another domestic corporation that does not, for the corporation's taxable year in which such securities are acquired by the taxpayer seeking nonrecognition treatment, have passive investment income (within the meaning of sec. 1362(d)(3)(D)) exceeding 25 percent of such corporation's gross receipts for that taxable year.

Exclusive benefit

Nonrecognition treatment is not available if assets attributable to qualified securities involved in a nonrecognition transaction accrue directly or indirectly for the benefit of (1) the taxpayer involved in the nonrecognition transaction, (2) any member of the taxpayer's family (within the meaning of sec. 267(b)), or (3) any other person who owns (after application of the sec. 318 attribution rules) more than 25 percent in value in any class of any outstanding employer securities.

If within the period of the applicable statute of limitations, assets attributable to qualified securities involved in a nonrecognition transaction accrue directly or indirectly for the benefit of an individual in one of these three categories, the gain realized on the sale of the qualified securities to the ESOP or EWOC will be recognized.

Although compliance with the restriction on the allocation of qualified securities is a condition of nonrecognition treatment, it is not a plan qualification requirement under present law.

Election and notice requirement

The taxpayer seeking nonrecognition treatment is required to file with the Secretary of the Treasury (1) a written election to claim nonrecognition treatment; (2) a verified written statement from the employer whose employees participate in the ESOP or an authorized officer of the worker-owned cooperative; and (3) information regarding the qualified replacement property, i.e., a "statement of purchase."

To elect nonrecognition treatment under the Act, the seller must file a written election, as prescribed by the Secretary of the Treasury, not later than the due date of the seller's income tax return for the seller's taxable year in which the sale occurs.

In addition, nonrecognition treatment is not available unless the seller files with the Secretary a verified written statement of the employer or an authorized officer of the corporation consenting to the application of the section 4978 excise tax.

Finally, the seller is required to provide a statement of purchase to the Secretary identifying (1) the seller's cost of acquiring replacement property (and an identification of such property), (2) the seller's intention not to acquire replacement securities within the replacement period, or (3) the seller's failure to acquire replacement securities within the replacement period. The form and manner of such notice is to be prescribed by the Secretary. Treas-

ury regulations would require that a taxpayer have a statement of purchase notarized within 30 days after the purchase of qualified replacement property.[14]

Disposition of qualified replacement property

In general, the Act provides that the basis of the taxpayer in qualified replacement property is reduced by an amount not greater than the amount of gain realized on the sale of qualified securities to the employee organization which was not recognized pursuant to the election provided by this provision. The gain is to be recognized upon disposition of the qualified replacement property. However, the Act did not clarify the impact of any other rules that otherwise might permit nonrecognition treatment upon a direct or indirect disposition of the qualified replacement property.

Explanation of Provisions

Qualified securities; qualified replacement property

The bill makes several clarifying changes to the definition of qualified securities and qualified replacement property.

With respect to qualified securities, the bill makes it clear that stock of a corporation with no readily tradable stock outstanding may be eligible for nonrecognition treatment whether or not the corporation or any member of the controlled group has outstanding any readily tradable debt securities. The bill also clarifies that the nonrecognition provision applies only if the gain on the sale would otherwise have been long-term capital gain. For example, the sale of securities that had been held for less than six months, and the sale of securities which otherwise would be treated as ordinary income (e.g., by reason of the collapsible corporation provisions) will be ineligible for nonrecognition treatment under this provision.

With respect to qualified replacement property, the bill makes it clear that securities issued by a government or political subdivision may not be treated as replacement property.

Qualified replacement property is limited under the bill to securities issued by a domestic operating corporation other than the corporation that issued the securities involved in the nonrecognition transaction. The bill generally defines a domestic operating corporation as a corporation substantially all the assets of which were, at the time the securities were purchased, used in the active conduct of a trade or business.

If (1) the corporation issuing the qualified replacement property owns stock representing control of one or more other corporations, or (2) one or more other corporations own stock representing control of the corporation issuing the qualified replacement property, then all such corporations will be treated as one corporation for purposes of determining whether the corporation is a domestic operating corporation and for purposes of determining whether the corporation that issued the qualified replacement property also issued the qualified securities. For purposes of this provision, control means control within the meaning of section 304(c), except that

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[14] See, generally, Temp. Treas. Reg. sec. 1.1042-IT.

in testing control for this purpose, qualified replacement property of the electing taxpayer attributable to that sale is disregarded. Thus, the stock of a start-up company will constitute qualified replacement property, notwithstanding the fact that the start-up company and the corporation that issued the securities involved in the nonrecognition transaction are treated as the same corporation under section 304(c).

The bill also clarifies that the stock of a bank or thrift institution will not be ineligible to be treated as qualified replacement property solely because the institution has passive income in excess of 25 percent of its gross receipts for the preceding year.

Finally, the bill clarifies that, in the case of the death of an individual who sold qualified securities to an ESOP, the executor of the individual's estate may invest the proceeds (within 12 months after the date of the sale) in qualified replacement property pursuant to an election under section 1042. The executor similarly could designate as qualified replacement property any property acquired by the decedent for which a statement of purchase has not been filed. The estate's basis in the qualified replacement property is to be determined under the general principles applicable under section 1042. A beneficiary who receives the qualified replacement property from the estate has a basis in the property equal to that of the executor's in the property, rather than the fair market value of the property on the date that the beneficiary acquires it.

Further, the bill provides an extended replacement period for sellers who had acquired replacement property that, pursuant to this bill, will no longer be considered qualified replacement property. Under the bill, if a security was acquired by a taxpayer prior to September 27, 1985, and such security no longer constitutes qualifying replacement property, the period of time for the purchase of qualified replacement property is extended to December 31, 1986. Of course, this extension does not increase the amount of gain for which nonrecognition treatment may be claimed.

Thirty-percent test

Under the bill, it is clarified that the ESOP or eligible worker-owned cooperative must hold, immediately after the sale, at least 30 percent of the total number of shares of all classes of stock (other than preferred stock described in section 1504(a)(4)) or 30 percent of the total value of all stock of the corporation that issued the qualified securities. With respect to sales after September, 27, 1985, in taxable years ending after that date, 30-percent ownership by the employee organization is to be tested after application of the ownership attribution rules of Code section 318(a)(4).

The requirement that the plan hold 30 percent of outstanding stock (after application of sec. 318(a)(4)) is effective for sales of securities after July 18, 1984.

Exclusive benefit

The bill makes several clarifying changes to the requirement that the employee organization be maintained for the exclusive benefit of employees. First, the bill clarifies that no portion of the assets attributable to qualified securities with respect to which a nonrecognition election is made (sec. 1042 securities) may be allo-

cated to (1) a taxpayer seeking nonrecognition treatment, (2) any person who is related to that taxpayer in one of the ways described in Code section 267(b), or (3) any other person who owns (after application of the attribution rules of Code section 318(a)) more than 25 percent (by number) of (a) any class of outstanding stock of the corporation that issued such qualified securities, or (b) any class of stock of certain related corporations.

In addition, the bill makes it clear that this restriction applies to prohibit any direct or indirect accrual of benefits under all qualified plans of an employer or an allocation of assets attributable to the qualified securities involved in the nonrecognition transaction. Thus, for example, an ESOP in which the taxpayer seeking nonrecognition treatment participates could not allocate to the taxpayer's account any assets attributable to the securities involved in the nonrecognition transaction. Nor could the employer make an allocation of other assets to the taxpayer under the ESOP without making additional allocations to other participants sufficient separately to satisfy the nondiscrimination requirements of Code section 401(a).

The bill clarifies that an individual is to be treated as a 25-percent shareholder only if the individual is a 25-percent shareholder (1) at any time during the one-year period ending on the date of the sale of section 1042 securities to an ESOP, or (2) on the dates upon which any section 1042 securities sold to the ESOP are allocated. In the case of an individual who satisfies the condition described at (1), the individual will continue to be treated as a 25-percent shareholder until all of the qualified securities acquired pursuant to the sale are allocated. In the case of an individual who does not satisfy the condition described at (1), but meets the condition described at (2), the individual will be treated as a 25-percent shareholder only with respect to those section 1042 securities allocated on the date or dates that the individual is a 25-percent shareholder.

The bill also provides that, for purposes of determining whether an individual owns more than 25 percent of the outstanding stock of the corporation which issued the employer securities, all allocated securities held by an ESOP are treated as securities owned by the ESOP participant to whom the securities are allocated. The treatment of shares held by an ESOP as held by a shareholder for purposes of applying the 25-percent test applies to sales of qualified securities after enactment.

The bill also provides that individuals who would be ineligible to receive an allocation of qualified securities *solely* because they are lineal descendants of other individuals who are ineligible to receive allocations of section 1042 securities may receive an allocation of the section 1042 securities provided that the total amount of such securities allocated to all such lineal descendants is not more than 5 percent of all section 1042 securities.

Disqualification

The bill also provides that an ESOP that acquires section 1042 securities is required to comply with the restriction on the allocation of securities to the sellers, family members, and 25-percent shareholders (sec. 409(n)). The sanction for failure to comply with

the restriction would be disqualification of the plan with respect to those participants who received prohibited allocations. Thus, failure to comply results in income inclusion for those participants of the value of their prohibited allocations on the date of such allocations. However, violation of the restriction does not cause disqualification of the plan if the violation occurred more than ten years after all of the section 1042 securities acquired in the transaction had been allocated.

Under the bill, if there is a prohibited allocation by an ESOP or an eligible worker-owned cooperative of employer securities acquired in a section 1042 transaction, then a 50 percent excise tax is imposed on the amount involved in the prohibited allocation. A prohibited allocation means (1) any allocation of employer securities acquired in a qualified sale if the provisions of section 409(n), relating to prohibitions on allocations to certain individuals, are violated and (2) any benefit accruing to a person in violation of the provisions of section 409(n). The liability for this excise tax is to be paid by the employer who maintains an ESOP or by the eligible worker-ownded cooperative.

Eligible taxpayers

Generally, effective for sales after March 28, 1985, the bill limits the class of taxpayers eligible to elect nonrecognition treatment under this provision by making the election unavailable to any subchapter C corporation. However, a subchapter C corporation may elect nonrecognition treatment with respect to certain sales made no later than July 1, 1985, provided the sales otherwise satisfy the requirements of this provision and are made pursuant to a binding contract in effect on March 28, 1985, and at all times thereafter. The bill provides an exception to the March 28, 1985, date for 2 transactions.

Election and notice

The bill clarifies that a taxpayer making a section 1042 election is not required to obtain a notarized "statement of purchase" describing the qualified replacement property until 90 days after the later of (1) the sale of the qualified securities, or (2) the purchase of the qualified replacement property. The bill would also direct the Secretary of the Treasury to provide forms for the election of nonrecognition treatment under section 1042 and for the "statement of purchase" describing the qualified replacement property. Anyone electing nonrecognition treatment under section 1042 would be required to use such forms for sales occurring 180 days after the publication of such forms.

Disposition of qualified replacement property

The bill also clarifies the coordination of the provision's requirement that gain be recognized upon disposition of any qualified replacement property with other rules providing nonrecognition treatment. Effective for dispositions made after the date of enactment, the bill overrides all other provisions permitting nonrecognition and requires that gain realized upon the disposition of qualified replacement property be recognized at that time. The bill exempts from the rule that gain is to be recognized upon the disposi-

tion of qualified replacement property: (1) dispositions at death; (2) dispositions by gift; (3) certain exchanges required in the event of a reorganization provided the corporation involved in the reorganization is not controlled by the taxpayer holding qualified replacement property; and (4) subsequent sales of the qualified replacement property to an ESOP, pursuant to a transaction governed by section 1042.

The amount of gain required to be recognized upon the disposition of qualified replacement property is limited to the amount not recognized pursuant to the election provided by this provision by reason of the acquisition of such replacement property. Any gain in excess of that amount continues to be eligible for any otherwise applicable nonrecognition treatment.

To ensure that this rule is not avoided through the use of controlled corporations, the bill provides special rules for corporations controlled by the taxpayer seeking nonrecognition treatment. If the taxpayer owns stock representing control (within the meaning of section 304(c)) of the corporation issuing the qualified replacement property, the taxpayer shall be treated as having disposed of such qualified replacement property when the corporation disposes of a substantial portion of its assets other than in the ordinary course of its trade or business.

b. Deduction for dividends paid on ESOP stock (sec. 1854(b) of the bill and sec. 404(k) of the Code)

Present Law

The Act permits an employer to deduct the amount of any dividends paid in cash during the employer's taxable year with respect to stock of the employer that is held by an ESOP (including a tax credit ESOP), but only to the extent such dividends are actually paid out currently to participants or beneficiaries. The employer may claim a deduction for dividends for the employer's taxable year when paid to the extent that the dividends (1) are, in accordance with the plan provisions, paid in cash directly to the participants, or (2) are paid to the plan and subsequently distributed to the participants in cash no later than 90 days after the close of the plan year in which paid.

For income tax purposes, dividends distributed under an ESOP, whether paid directly to participants pursuant to plan provisions or paid to the plan and redistributed to participants, generally are treated as plan distributions. Accordingly, such dividends do not qualify for the partial exclusion from income otherwise permitted under Code section 116.

Explanation of Provision

The bill makes it clear that dividends paid on any employer stock held by the ESOP and allocated as of the date of distribution to a participant's account may be deducted under this provision, including those dividends paid on employer stock that is not considered to be qualified employer securities within the meaning of section 409(l). No deduction is permitted, however, with respect to employer stock held in a suspense account (as of the date of distribu-

tion) under an ESOP. The bill clarifies that a deduction is permitted for dividends paid on stock which is allocated to participants' accounts as of the date of distribution of such dividends. The bill also makes it clear that current distributions of dividends paid on employer stock allocated to a participant's account under an ESOP will not be considered disqualifying distributions.

The bill clarifies that a corporation will be allowed a deduction for dividends paid on stock held by an ESOP whether such dividends are passed through to beneficiaries of plan participants or to the plan participants themselves. In addition, effective for dividends paid after the date of the bill's enactment, the bill makes it clear that employer deductions for dividends paid on employer stock held by an ESOP are to be permitted only in the year in which the dividend is paid or distributed to the participant beneficiary. Thus, where the employer pays such dividends directly to participants in accordance with plan provisions, a deduction would be permitted in the year paid. However, where the employer pays such dividends to the ESOP for redistribution to participants no later than 90 days after the close of the plan year, a deduction would be permitted in the employer's taxable year in which the dividend is distributed from the ESOP to the participants. The bill clarifies that dividends paid on employer stock held by an ESOP are treated as paid under a contract separate from the contract under which the stock is held. However, the provision is inapplicable to dividends paid before January 1, 1986, if the employer deducted such dividends in the taxable year they were paid to the ESOP and filed a return for that taxable year before the date of enactment.

The bill clarifies that, although the dividends for which the Act allows a deduction are generally to be treated as distributions under the plan, they are to be fully taxable. Thus, these distributions are not to be treated as distributions of net employee contributions. The provision is inapplicable to dividends paid before January 1, 1986, which a taxpayer treated as the nontaxable return of employee contributions for purposes of a return filed before the date of enactment.

Further, the bill empowers the Treasury to disallow deductions for dividends paid on stock held by an ESOP, if the dividend constitutes, in substance, the avoidance of taxation. Thus, for example, if amounts paid by an employer, and treated for tax purposes as 404(k) dividends, are the payment of unreasonable compensation, such payments would not qualify for treatment as section 404(k) dividends.

c. Partial exclusion of interest earned on ESOP loans (sec. 1854(c) of the bill and sec. 133 of the Code)

Present Law

A bank (within the meaning of sec. 581), an insurance company, or a corporation actively engaged in the business of lending money may exclude from gross income 50 percent of the interest received with respect to a securities acquisition loan.

Under the Code, a securities acquisition loan means any loan to a corporation or to an ESOP to the extent that the proceeds are used to acquire employer securities (within the meaning of sec. 409(l)) for the plan. A securities acquisition loan does not include any loan between corporations that are members of the same controlled group of corporations.

Temporary regulations issued by the Treasury provide that a loan made to a corporation sponsoring an ESOP will qualify as a securities acquisition loan only to the extent that, and for the period which, the proceeds are (a) loaned to the corporation's ESOP on terms "substantially similar" to those between the commercial lender and the sponsoring organization and (b) used to acquire employer securities for the ESOP. However, the term "securities acquisition loan" excludes any loan made between corporations that are members of the same controlled group of corporations.

Explanation of Provision

The bill (1) clarifies the interaction of the partial interest exclusion with other provisions affecting tax-exempt income, and (2) clarifies the meaning of the term "securities acquisition loan."

Interaction with other provisions.—The bill makes it clear that for purposes of section 291(e), relating to certain tax preference items, (1) interest on an obligation eligible for the partial exclusion of section 133 will not be treated as exempt from tax, and (2) in determining the interest allocable to indebtedness on tax-exempt obligations, obligations eligible for the partial exclusion will not be taken into account in calculating the taxpayer's average adjusted basis for all assets.

In addition, the bill clarifies the coordination of the partial exclusion with the installment payment provisions (sec. 483) and the original issue discount rules (secs. 1271 through 1275). The bill makes it clear that, in testing the adequacy of the stated interest rate for purposes of section 483 and sections 1271 through 1275, the applicable Federal rate will be adjusted as appropriate to reflect the partial interest exclusion. In addition, the bill clarifies that the below market interest rate rules (sec. 7872) do not apply to a loan between a sponsoring employer and an ESOP, provided that the interest rate payable on such loan is no less than the interest rate payable by the employer on a corresponding section 133 loan.

Securities acquisition loan.—The bill would clarify the definition of the term "securities acquisition loan" in several respects. First, the bill would make it clear that the refinancing of a loan to an ESOP after the effective date of section 133 will qualify as a securities acquisition loan, provided that the repayment period of the original loan is not extended, and the refinanced loan otherwise satisfies the requirements of section 133. Thus, for example, loans used to acquire employer securities after July 18, 1984, qualify for such refinancing notwithstanding that the original loan would not have qualified as a securities acquisition loan under section 133. For example, if a purchase money obligation was utilized to acquire employer securities after July 18, 1984, the refinancing of such loan is permitted to qualify under section 133.

The bill also clarifies that the requirement that a loan from a sponsoring corporation to an ESOP be made on terms "substantially similar" to those applicable to the loan between a commercial lender and the sponsoring corporation does not preclude repayment of the sponsoring corporation's loan to the ESOP more rapidly than the repayment of the loan from the commercial lender to the sponsoring corporation, provided that the allocations of stock within the ESOP do not result in discrimination in favor of highly compensated employees. The terms of such loans are to be negotiated between the plan's sponsor and the lender; however, the repayment period of the loan from the commercial lender could not be more than 7 years unless the repayment terms of the two loans are substantially similar.

The bill would also clarify that, although a securities acquisition loan may not originate with any member of the controlled group, it may be held by a member of the controlled group. However, during any such time that a securities acquisition loan is held by a member of the controlled group, any interest received with respect to such loan during such period would not qualify for the exclusion provided under section 133.

d. Payment of estate tax liability by ESOP (sec. 1854(d) of the bill and sec. 2210 of the Code)

Present Law

If qualified employer securities are (1) acquired from a decedent by an ESOP or an eligible worker-owned cooperative (EWOC), (2) pass from a decedent to an ESOP or EWOC, or (3) are transferred by the decedent's executor to an ESOP or EWOC, then the executor of the decedent's estate generally is relieved of the estate tax liability to the extent the ESOP or EWOC is required to pay the liability.

No executor is relieved of estate tax liability under this provision with respect to securities transferred to an ESOP unless the employer whose employees participate in the ESOP guarantees, by surety bond or other means as required by the Secretary of the Treasury, the payment of any estate tax or interest.

To the extent that (1) the decedent's estate is otherwise eligible to make deferred payments of estate taxes pursuant to section 6166 with respect to the decedent's interest in qualified employer securities, and (2) the executor elects to make payments pursuant to that section, the plan administrator of the ESOP or an authorized officer of the EWOC also may elect to pay any estate taxes attributable to the qualified employer securities transferred to the ESOP or EWOC in installments pursuant to that section. The Act provides that the usual rules (sec. 6166) apply to determine ongoing eligibility for deferral. Thus, for example, disposition of the qualifying securities held by the estate and employee organization may trigger acceleration of any remaining unpaid tax.

Explanation of Provision

The bill makes several changes to clarify the applicability of these provisions and the coordination with the provisions govern-

ing the installment payment of estate taxes under section 6166. First, the bill makes it clear, that, with respect to the estates of individuals dying after September 27, 1985, only executors of those estates eligible to make deferred payments of estate taxes may be relieved of estate tax liability under this provision. In addition, under the bill, the transfer of employer securities to an ESOP or to an eligible EWOC will not be treated as a disposition or withdrawal which triggers acceleration of the remaining unpaid tax.

The bill makes it clear that, after the transfer, the ongoing eligibility of the estate and the ESOP or EWOC to make installment payments applicable to their respective interests is to be tested separately. Thus, with respect to the estate's remaining interest (if any), cumulative dispositions and withdrawals of amounts up to 50 percent of the estate's remaining interest would be permitted without requiring acceleration of the remaining unpaid tax. Similarly, with respect to an ESOP or EWOC cumulative dispositions and withdrawals of up to 50 percent of the interest transferred to the ESOP or EWOC would be permitted without requiring acceleration. In addition, under the bill, a distribution made by an ESOP to participants on account of death, retirement after attainment of age 59-1/2, disability, or any separation from service resulting in a one-year break in service will not be treated as a disposition requiring acceleration of any unpaid tax and will not be taken into account in determining whether any subsequent disposition triggers acceleration.

The bill also makes it clear that no executor will be relieved of estate tax liability with respect to employer securities transferred to an eligible EWOC unless the EWOC guarantees the payment of any estate tax or interest by surety bond or other means as required by the Secretary of the Treasury.

6. Voting Rights (sec. 1854(f) of the bill and sec. 409 of the Code)

Present Law

Under present law, a tax credit ESOP (sec. 409), a leveraged ESOP and, in some circumstances, a defined contribution plan (sec. 401(a)(22)) are required to meet certain voting rights requirements with respect to employer securities held by the plan. If the plan does not have a registration-type class of securities, the trustee of the plan is required to permit each participant to direct the vote with respect to corporate matters that (by law or charter) must be decided by more than a majority vote of the outstanding common shares voted, of those securities that have been allocated to the participant's account.

Explanation of Provision

The bill modifies the voting rights requirements applicable to nonregistration type employer securities held by an ESOP by (1) mandating that voting rights be passed through to participants with respect to certain enumerated issues; and (2) accommodating the one man-one vote philosophy of certain types of ESOPs and EWOCs.

First, the bill would require, with respect to certain issues specified in the bill, that a trustee permit participants to direct the vote under employer securities allocated to the participants' accounts, regardless of whether the issue was required (by law or charter) to be decided by more than a majority vote of the outstanding common shares voted. The issues on which the pass-through of voting rights would be required include merger or consolidation, recapitalization, reclassification, liquidation, dissolution, or sale of substantially all of the assets of a trade or business of the corporation, and to the extent provided by regulations, other similar issues.

Second, the bill would permit the trustee of an ESOP or EWOC, the by-laws or terms of which required that the interests in the ESOP or EWOC be governed on a one vote per participant basis, to vote the employer securities in a manner that reflected the one man-one vote philosophy. Under this alternative, each ESOP or EWOC participant would be entitled to cast one vote on an issue. The trustee would then be required to vote the employer securities held by the ESOP or EWOC in proportion to the results of the votes cast on the issue by the participants.

The requirements relating to one vote per participant are effective on the date of enactment. The requirements relating to pass-through voting are effective after December 31, 1986 for securities acquires after December 31, 1979.

7. Miscellaneous Provisions

a. Incentive stock option provision (sec. 1855(a) of the bill and secs. 57 and 422A of the Code)

Present Law

The Act clarifies that the fair market value of stock, for purposes of applying the incentive stock options provisions, is determined without regard to lapse restrictions.

The Act applies, for purposes of the minimum tax, to options exercised after March 20, 1984. Transitional relief was provided for certain options exercised on or before December 31, 1984.

Explanation of Provision

The bill clarifies that, under the transitional rule, the amendment to the minimum tax provision relating to incentive stock options (sec. 57(a)(10)) will not apply to options exercised before January 1, 1985, if the option was granted pursuant to a plan adopted or corporate action taken by the board of directors of the grantor corporation before May 15, 1984.

b. Certain transfers of property subject to restrictions (sec. 1855(b) of the bill and sec. 252 of ERTA)

Present Law

The Economic Recovery Tax Act of 1981 provided that stock subject to the restrictions of section 16(b) of the Securities Exchange Act of 1934 is treated as being subject to a substantial risk of for-

feiture and nontransferable for the six-month period following receipt of the stock during which that section applies. Thus, unless the taxpayer elects (under sec. 83(b)) to be taxed when the stock is received, the taxpayer must include in income (and the employer may deduct), at the expiration of the period during which section 16(b) is applicable, the value of the stock at such time, less any amount the taxpayer paid for the stock.

Explanation of Provision

The bill permits certain individuals who received stock in 1973 pursuant to the exercise of employee stock options to elect to have section 252 of the Economic Recovery Stock Act of 1981 apply retroactively (i.e., with respect to transfers before December 31, 1981) in certain limited circumstances. Under the bill, any reduction in tax pursuant to such election could not exceed $100,000 with respect to any one employee. The statute of limitations is amended by the bill to permit refunds or credits, or assessments, attributable to the provisions of the bill.

c. Net unrealized appreciation (sec. 1854(g) of the bill and sec. 402 of the Code)

Present Law

Under present law, in the case of a distribution of securities of the employer from a qualified plan, an employee is permitted to exclude from income the net unrealized appreciation (NUA) on such securities attributable to employee contributions. In addition, if the distribution qualifies as a lump-sum distribution, the employee is generally permitted to exclude from income the NUA on such securities, regardless of whether appreciation is attributable to employer or employee contributions (secs. 402(a)(1) and 402(e)(4)(J)). Upon disposition of the stock in a taxable transaction, the participant is taxed on the previously excluded NUA at capital gains rates. NUA is generally measured as the difference between the fair market value at distribution and the basis of the securities.

In the case of an acquisition of one corporation by another, shares of the company held by a plan sponsored by the company, are sometimes exchanged for shares of the acquiring company in a transaction that generally would be taxable if the stock were not held by a qualified plan. Alternatively, the plan may exchange shares of the target company for cash or other property that the plan later reinvests in qualifying securities of the employer. The IRS has taken the position that in a case in which securities of the employer held by a plan are exchanged for cash or other securities of the employer in a transaction that would be taxable if the securities were held by a taxable entity, the plan's basis in such securities received pursuant to the exchange (or purchased with cash or other property received pursuant to the exchange) is generally increased or "stepped up" to reflect the fair market value of the securities, cash, or property used to acquire new securities. Because the newly acquired securities have a "stepped-up" basis, rather than the same basis as the securities that were disposed of in the

exchange, the previously accumulated NUA on the old securities is eliminated.

Explanation of Provision

The bill provides that if, pursuant to a tender offer, a plan fiduciary, in the exercise of its fiduciary duties, exchanges previously acquired securities of the employer for other securities of the employer, the plan will have the same basis in the acquired securities as it had in the securities exchanged for the acquired securities. Similarly, if a plan fiduciary, in the exercise of its fiduciary duties, disposes of such securities for cash because the securities are called, because the trustee tenders such securities in response to a tender offer, or because such disposition is required by ERISA or the Internal Revenue Code, and the proceeds are reinvested in securities of the employer within a 90-day period (unless the Secretary provides an extension of the 90-day period) the plan will have the same basis in such securities purchased with the cash proceeds as the plan had in the securities sold. In the case of a transaction occurring before the date of enactment, the reinvestment period does not end before the earlier of (1) one year after the date of the transaction or (2) 180 days after the date of enactment.

F. Technical Corrections to the Tax-Exempt Bond Provisions

1. Mortgage revenue bond and mortgage credit certificate provisions (secs. 1861–1863 of the bill and secs. 25 and 103A of the Code)

Present Law

Mortgage revenue bonds

The Act extends the tax-exemption for qualified mortgage bonds for four years, for bonds issued after December 31, 1983, and before January 1, 1988. These bonds generally are subject to the same restrictions as applied to such bonds issued before January 1, 1984.

The Act restricts the issuance of qualified veterans' mortgage bonds by (1) limiting the veterans eligible for loans financed with these bonds, and (2) imposing State volume limitations based on pre-1984 issuance of the bonds. The Act further directs the Federal Financing Bank to make cash flow loans to the Oregon Department of Veterans' Affairs to offset lower than anticipated prepayments on loans funded with specified veterans' mortgage bonds.

Mortgage credit certificates

As an alternative to qualified mortgage bonds, the Act permits States to elect to exchange qualified mortgage bond authority for authority to issue mortgage credit certificates (MCCs). MCCs generally are subject to the same eligibility restrictions as qualified mortgage bonds.

Explanation of Provisions

Mortgage revenue bonds

The bill clarifies that, in certain cases, the Treasury Department may grant extensions of time for publishing annual policy statements that issuers of qualified mortgage bonds are required to make. These statements must explain measures taken by the issuers to comply with the Congressional objective of providing housing for lower-income persons.

The bill further clarifies that the requirement of this annual policy statement and the requirements that (1) certain information be reported to Treasury with respect to each bond issue and (2) a State official certify compliance with Code restrictions are treated as satisfied if the issuer in good faith attempted to meet the requirement and the failure to meet the requirement is due to inadvertent error.

The bill clarifies that veterans eligible for loans financed by qualified veterans' mortgage bonds must apply for the financing before the later of (1) 30 years after leaving active service, or (2) January 31, 1985 (rather than January 1, 1985).

The bill provides that the Oregon Department of Veterans' Affairs (Oregon) may advance refund up to $300 million of qualified veterans' mortgage bonds and expands the list of specified bonds that may be advance refunded. (Advance refundings of mortgage subsidy bonds generally are prohibited.) The advance refunding is in lieu of authority included in the Act permitting that State agency to receive cash flow loans not exceeding $300 million at any time from the Federal Financing Bank (FFB). This provision is effective on the date of enactment, and does not affect the status of cash flow loans made under an interim financing agreement entered into between Oregon and the FFB before that date.

Mortgage credit certificates

Issuers of qualified mortgage bonds must satisfy information reporting requirements, must certify that the bonds meet the volume limitation requirement of the Code, and must publish annual policy statements demonstrating that their programs satisfy Congress' objective in authorizing issuance of tax-exempt bonds for this purpose. The bill clarifies that these requirements also apply with respect to MCCs.

The bill clarifies that good faith errors in MCC program administration may be corrected without invalidating all MCCs issued under the program. The bill further clarifies the method for determining the amount of excess credit that may be carried forward for up to three years by a taxpayer.

2. Private activity bond provisions (secs. 1864–1873 of the bill and sec. 103 of the Code)

Present Law

Volume limitations

Private activity bonds generally are subject to State volume limitations. The limitations apply to most industrial development

bonds (IDBs) and to student loan bonds issued within the State. Certain bonds issued to finance governmentally owned airports, docks, wharves, convention or trade show facilities, and mass commuting facilities are not subject to these volume limitations.

The Act provides a statutory formula for allocating each State's volume limitation among issuers within the State. This Federal formula may be overridden by State statute, or by gubernatorial proclamation on an interim basis. Issuers may elect to carry forward bond authority for up to three years (six years in certain cases) for certain, specifically identified projects.

Prohibition on Federal guarantees of tax-exempt bonds

The Act provides that interest on bonds, repayment of which is directly or indirectly guaranteed (in whole or in part) by the Federal Government, is taxable. The underlying economic substance of a transaction determines whether repayment of bonds is Federally guaranteed. Thus, depending on the facts and circumstances of each case, a Federal guarantee may arise from contracts providing for purchase of the output of a facility by the Federal Government, from leases of property to the Federal Government, and from other similar arrangements, as well as from a direct agreement to repay the bonds.

Additional arbitrage restrictions for most IDBs and for student loan bonds

In the case of IDBs (other than IDBs for multifamily residential rental property), the Act limits the amount of bond proceeds that may be invested in obligations not related to the purpose of the borrowing and requires rebates to the Federal Government of arbitrage profits in certain cases. The Act also directs the Treasury Department to prescribe regulations extending additional arbitrage restrictions similar to those for most IDBs to student loan bonds.

$40 million limit on small-issue IDBs

The Act prohibits tax-exemption for small-issue IDBs if a beneficiary of the IDBs is a beneficiary of more than $40 million of all types of tax-exempt bonds. Bonds used to redeem other bonds do not count towards the $40 million limit; however, such refunding bonds may not be issued if a beneficiary of the bonds benefits from more than $40 million of outstanding bonds at the time of the refunding.

Private (consumer) loan bonds

The Act provides that interest on bonds generally is not tax-exempt if five percent or more of the proceeds is reasonably expected to be used, directly or indirectly, to make loans to nonexempt persons. Exceptions are provided for IDBs, qualified student loan bonds, mortgage revenue bonds, and for certain bonds used to finance assessments or taxes of general application for an essential governmental function.

As enacted in 1984, this restriction makes no distinction between bonds that are used to finance loans for businesses and bonds used to finance personal loans. For example, an issue may be in violation of this restriction if 5 percent or more, but no more than 25

percent, of the proceeds is used to provide financing that would be considered IDB-financing, but for the fact that bonds are not treated as IDBs if no more than 25 percent of the proceeds is used for a purpose described in section 103(b). Similarly, an obligation that would be an IDB except for the fact that the security interest test of section 103(b)(2)(B) is not satisfied may be in violation of this restriction.

Restriction on acquisition of existing facilities

The Act restricts tax-exempt financing for the acquisition of existing facilities to cases where an amount equal to at least 15 percent of the bonds is spent on rehabilitation of a building and associated equipment. In the case of structures other than buildings, the rehabilitation expenditures must equal or exceed the amount of bond financing.

Application of certain Internal Revenue Code requirements to bonds exempt from tax pursuant to other provisions of law

The Act provides that bonds issued pursuant to provisions of law other than the Internal Revenue Code must satisfy appropriate Code requirements as a condition of tax-exemption. Examples of these requirements are the Code restrictions on IDBs, the arbitrage rules, the prohibition on Federal guarantees of tax-exempt bonds, the State volume limitations, and the public approval and information reporting requirements.

Small-issue IDB principal user rule

Small-issue IDBs generally may not exceed $1 million per issue. If a special election is made, this limit is increased to $10 million, but all capital expenditures that principal users of the facility incur within a prescribed period with respect to facilities located in the same municipality (or county, if not in any municipality) are aggregated with the amount of the bonds in determining whether the $10 million limit is exceeded.

Effective dates

Section 631 of the Act provides effective dates for the various tax-exempt bond provisions for which (1) no separately stated effective dates are included as part of the section of the Act containing the substantive rule, or (2) no effective dates are provided by means of dates included within substantive rules identifying the bonds to which the rules apply. Transitional exceptions are provided with respect to many of the provisions for which the effective dates are provided in Act section 631. Additionally, special exceptions are provided in Act sections 631 and 632 for certain specifically described facilities.

Explanation of Provisions

Volume limitations

Facilities located outside a State.—The bill clarifies that each State's annual private activity bond volume limitation generally may be used only to finance facilities located within that State. Under this clarification, a State may allocate a portion of its

volume limitation to financing for facilities located outside its boundaries only in the case of specified facilities, and only to the extent of the State's share of the use of those facilities.

Facilities located outside a State and to which a State may allocate a portion of its volume limitation include (1) otherwise eligible sewage and solid waste disposal facilities or facilities for the local furnishing of electric energy or gas (sec. 103(b)(4)(E)); (2) otherwise eligible facilities for furnishing of water (sec. 103(b)(4)(G)); and (3) qualified hydroelectric generating facilities (sec. 103(b)(4)(H)). This clarification does not affect the rule in Code section 103(o)(3) that qualified student loan bonds must be issued to finance loans both to (1) residents of the State issuing the bonds regardless of the location of the school the residents attend, and (2) students attending schools within the issuing jurisdiction, regardless of the State of their legal residence, since no facilities are financed with student loan bonds.

In the case of sewage and solid waste disposal facilities, the determination of a State's use of a facility is based on the percentage of the facility's total treatment provided to the State (and its residents). In the case of facilities for the local furnishing of electric energy and gas, facilities for the furnishing of water, and qualified hydroelectric generating facilities, the determination of use is based upon the share of the output of the facility received by the State (and its residents).

These clarifications generally are effective for bonds issued after the date of the bill's enactment. Under a special rule, a State may elect to apply this rule in the case of bonds issued before the date of enactment.

Certain facilities financed outside a State's volume limitation.—The bill clarifies that the determination of whether facilities forming a part of an airport, dock, wharf, mass commuting facility, or trade or convention center may be financed outside a State's volume limitation is to be made on a property-by-property basis rather than by reference to the entire airport or other excepted facility. Under the bill, all property to be financed pursuant to this exception must be owned by or on behalf of a governmental unit. Therefore, property financed with the so-called "insubstantial portion" of bond proceeds that otherwise could be used for a purpose other than the governmental purpose for which the bonds are issued also must be governmentally owned.

Authority to allocate a State's volume limitation directly to issuing authorities other than governmental units.—The bill clarifies that a State may allocate its private activity bond volume limitation directly to issuing authorities within the State that are not governmental units as well as to such governmental units. This clarification applies to allocations pursuant to gubernatorial proclamations and also to allocations pursuant to State statutes.

Reporting requirement for allocations of volume limitations.—The bill clarifies the authority of the Treasury Department to require reports on allocations of State volume limitations as part of the presently required information reporting (Code sec. 103(l)).

Prohibition on Federal guarantees

The bill provides transitional relief for a convention center (Carbondale, Illinois) to be financed with bonds for which the Farmers Home Administration had authorized a Federal guarantee before enactment of the Act.

The bill also provides transitional exceptions for a limited amount of bonds for four solid waste disposal facilities. Bonds for these facilities are indirectly Federally guaranteed as a result of the anticipated purchase by the Federal Government under contract of more than an insignificant portion of the output of the facilities. These facilities are located in Aberdeen and Annapolis, Maryland, in Portsmouth, Virginia, and in Charleston, South Carolina. Expenditures were made with respect to each facility before October 19, 1983.

Additional arbitrage restrictions for most IDBs and student loan bonds

The bill corrects a reference to a resource recovery project of Essex County, New Jersey, contained in a transitional exception to the additional arbitrage restrictions for most IDBs. Additionally, the bill clarifies the application of an exception for refundings of student loan bonds in the case of a series of refundings, and expands a transitional rule included in the Act for a Muskogee, Oklahoma project to include a limited exception from the arbitrage rebate rules for IDBs.

$40 million limit on small-issue IDBs

The bill permits small-issue IDBs to be refunded to reduce the interest rate on the borrowing even though a beneficiary of the bonds benefits from more than $40 million in tax-exempt financing. Small-issue IDBs may be refunded in such cases only if (1) the maturity of the refunded bonds is not extended; (2) the amount of the refunding bonds does not exceed the outstanding amount of the refunded bonds; (3) the interest rate on the refunding bonds is lower than the rate on the refunded bonds; and (4) the refunded bonds are redeemed no later than 30 days after issuance of the refunding bonds (i.e., called so that no interest accrues on the refunded bonds after such time).

Consumer loan bonds

The bill retitles consumer loan bonds "private loan bonds" to reflect the fact that, under that provision of the Act, all bonds issued to finance loans to nonexempt persons are subject to this restriction unless a specific exception is provided in the Code (e.g., the exceptions for IDBs, mortgage revenue bonds, qualified student loan bonds, and certain bonds to finance assessments or taxes of general application for an essential governmental function). This provision does not amend the substantive scope of the restriction, as enacted in 1984.

A transitional exception is provided for bonds issued before 1985 for the White Pine, Nevada power project, with respect to which indirect loans to nonexempt persons will be made through contracts providing the persons with a significant portion of the

output of the facilities. Additional transitional exceptions are provided for (1) certain bonds for the Mead-Phoenix power project for which other transitional relief was provided in the Act; and (2) up to $27 million of bonds for the City of Baltimore, Maryland, to finance advances made by that City on or before October 19, 1983, pursuant to a voter referendum held before November 3, 1982, and (3) for certain bonds issued by the Eastern Maine Electric Cooperative with respect to Project No. 6, a joint venture with the Massachusetts Municipal Wholesale Electric Company.

Application of certain Internal Revenue Code requirements to bonds exempt from tax pursuant to other provisions of law

The bill clarifies that bonds issued pursuant to provisions of law other than the Code (non-Code bonds) must be issued in registered form. Additionally, the bill clarifies that the private (consumer) loan bond restriction applies to non-Code bonds. These clarifications are effective for bonds issued after March 28, 1985.

Exception for small-issue IDB principal user rule

The bill provides an exception from the small-issue IDB size limitations for specified amounts of bonds for three hydroelectric generating facilities (Hastings, Minnesota, Warren County, New York, and Los Banos, California) output from which will be sold to a nongovernmental person pursuant to agreements in accordance with the Public Utilities Regulatory Policies Act of 1978 (PURPA). But for the amendment, the purchasers of power under these PURPA agreements would be treated as principal users of the facilities.

Effective dates

The bill clarifies the private activity bond provisions to which the effective dates provided in Act section 631(c)(1) apply. These provisions are (1) the prohibition on Federal guarantees (Act sec. 622); (2) the aggregate limit for small issue bonds (Act sec. 623); (3) the restrictions on financing land, existing facilities, and certain specified facilities (Act sec. 627); (4) the rules relating to aggregation of certain related facilities, the definition of substantial user, and mixed use residential rental property (Act secs. 628(c), (d), and (e)); (5) the option for student loan bond authorities to issue taxable bonds (Act sec. 625(c)); (6) the public approval requirements for certain airports (Act sec. 628(f)); and (7) the authorization of tax-exempt financing for acquisition of a bankrupt railroad (Act sec. 629(b)).

The bill clarifies that the transitional exceptions contained in Act section 631(c)(3) apply only in the case of certain of the provisions enumerated in section 631(c)(1), as amended.

The bill further clarifies that the exception for obligations to finance facilities the construction, reconstruction, or rehabilitation of which was begun before October 19, 1983, applies only if the construction, reconstruction, or rehabilitation was completed on or after that date. Similarly, the exception for obligations issued to finance facilities with respect to which a binding contract to incur significant expenditures for construction, reconstruction, rehabilitation, or acquisition was entered into before October 19, 1983, applies only if some of the expenditures are incurred on or after that

date. For purposes of the binding contract rule, payments under an installment payment agreement are incurred no later than the date on which the property that is the subject of the agreement is delivered rather than on the due date of each installment.

The two clarifications to these transitional exceptions requiring activity (e.g. construction) or expenditures after October 18, 1983, apply to obligations issued after March 28, 1985; however, no inference is intended that the same rules, do not apply to obligations issued on or before that date.

The bill clarifies that, subject to transitional exceptions, the prohibition on tax-exempt financing for health clubs applies to obligations issued after April 12, 1984 (rather than December 31, 1983).

Further, the bill provides that the private loan bond restriction of the Act does not apply to tax-increment financing bonds issued on or before the date of the bill's enactment. Tax-increment financing bonds eligible for this exception are bonds substantially all of the proceeds of which are to be used to finance—

(1) sewer, street lighting, or other governmental improvements to real property,

(2) the acquisition of any interest in real property pursuant to the exercise of eminent domain (or the threat thereof), the preparation of such property for new use, or the transfer of such interest to a private developer, or

(3) payments of reasonable relocation costs of prior users of such real property.

All of these activities must be carried out pursuant to a redevelopment plan adopted before the bonds are issued by the governing body of the general governmental unit in which the real property being redeveloped is located. Repayment of the bonds must be secured by pledges of that portion of any increase in real property tax revenues (or their equivalent) attributable to the redevelopment resulting from the issue. (The fact that a governmental unit may pledge its full faith and credit in addition to incremental property tax revenues does not violate this requirement.) Also, no facilities located (or to be located) on land acquired with tax-increment financing bond proceeds may be subject to a real property or other tax based on a rate or valuation method which differs from the rate and valuation method applicable to any other similar property located in the general governmental unit in which the real property being redeveloped is located. (The fact that property located in different tax assessment districts is subject to different assessments does not violate this restriction as long as no special assessments are levied with regard to the redevelopment activities.)

G. Technical Corrections to Miscellaneous Tax Provisions

1. Miscellaneous corporate provision (sec. 1875(b) of the bill and sec. 304 of the Code)

Present Law

Under present law, if a shareholder of a 50-percent owned corporation transfers stock of that corporation to another 50-percent owned corporation in exchange for property, the transaction is treated as a redemption of the shareholders' stock in the acquiring

corporation. The transferred stock is considered to have been transferred by the shareholders as a contribution to capital of the acquiring corporation, and its basis is equal to the transferor's basis increased by any gain recognized to the transferor (sec. 362(a)).

Explanation of Provision

The bill provides that the contribution to capital rule will not apply if the shareholder is treated as having exchanged its stock (under sec. 302(a)). Thus, where section 302(a) applies, the acquiring corporation will be treated as purchasing the stock, for example, for purposes of section 338. The amendment is not intended to change the present law treatment of the shareholder (including the shareholder's basis in the stock of the acquiring corporation).

2. Miscellaneous pension provisions (sec. 1875(c) of the bill and secs. 62, 219, 402, 404, and 408 of the Code)

Present Law

Rollovers

Under present law, as in effect before the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), a 10-percent additional income tax applied to distributions before age 59½, death, or disability from a qualified plan to an owner-employee (a sole proprietor who owned the entire interest in an unincorporated trade or business or a partner who owned more than 10 percent of a partnership). TEFRA extended the additional income tax on such early withdrawals made to key employees (sec. 416(i)). TEFRA did not, however, provide a conforming amendment to prevent avoidance of the tax through a tax-free rollover by a key employee to a plan in which the individual was not a key employee.

The Deficit Reduction Act of 1984 (DEFRA) provided a conforming amendment to prohibit rollovers by key employees to plans for which the additional tax on early withdrawals was inapplicable. However, DEFRA also amended the additional tax on early withdrawals to apply to individuals who are 5-percent owners of the employer, whether or not those individuals are key employees. Thus, after DEFRA, there continues to be a discrepancy between the class of individuals to whom the additional tax on early withdrawals applies (i.e., 5-percent owners) and the class of individuals for whom rollovers are restricted (i.e., key employees).

Excess contributions

Under prior law, contributions made to a qualified plan on behalf of a self-employed individual in excess of the amount deductible for the taxable year were subject to an excise tax, unless the excess was withdrawn before the due date of the tax return. DEFRA repealed this tax on excess contributions and the provision relating to the return of excess contributions, effective for taxable years beginning after December 31, 1983.

Deduction limits for self-employed individuals

Generally, effective for years beginning after December 31, 1983, TEFRA revised the definition of earned income so that the amount

taken into account as the earned income of a self-employed individual corresponds to the amount of compensation of a common-law employee. Under TEFRA, in applying the rules relating to deductions and limitations under qualified plans, the earned income of a self-employed individual was computed after taking into account contributions by the employer to a qualified plan to the extent a deduction is allowed for the contributions. This provision was not intended to apply for purposes of determining whether contributions made on behalf of a self-employed individual are ordinary and necessary business expenses.

IRAs, SEPs

TEFRA generally increased the overall limits on contributions and benefits attributable to self-employed individuals to conform to the generally applicable limits under qualified plans.

Overall limits

Generally, effective for years ending after July 1, 1982, TEFRA reduced the overall limits on contributions and benefits under qualified plans, tax-sheltered annuity programs, and simplified employee pensions (SEPs). TEFRA also provided rules for calculating the dollar limits applicable to alternate forms of benefits, benefits commencing prior to age 62, and benefits commencing after age 65. In calculating employer contributions required to fund benefit amounts not in excess of those limits (and deductions for those contributions), TEFRA provided that anticipated cost-of-living increases are not taken into account.

Pension withholding

Under present law, payors generally are required to withhold tax from a designated distribution (the taxable part of a payment made from or under a pension, profit-sharing, stock bonus, or annuity plan, an IRA, a commercial annuity, and certain deferred compensation plans), unless the recipient elects not to have withholding apply. The withholding rules do not apply to certain distributions, such as those distributions that are otherwise considered wages.

Contributions on behalf of disabled individuals

TEFRA permitted an employer to elect to continue making deductible contributions to a profit-sharing or stock bonus plan on behalf of a permanently and totally disabled employee who has separated from service. A similar rule does not apply for contributions to a money purchase pension plan.

Explanation of Provisions

Rollovers

The bill coordinates the rules relating to qualifying rollover distributions (secs. 402(a)(5)(F)(ii) and 408(d)(3)) with those applicable to the additional income tax on early withdrawals. Distributions made after the date of enactment of this bill to or on behalf of an individual who is a 5-percent owner at the time of distribution may not be rolled over to a qualified plan.

The bill provides that distributions after December 31, 1983, but before July 18, 1984, may not be rolled over to a qualified plan if any part of the distribution is attributable to contributions made on behalf of an owner-employee. In addition, distributions made after July 18, 1984, but before the enactment of this bill, may not be rolled over to a qualified plan if any part of the distribution is a benefit attributable to contributions made on behalf of an employee while a key employee (but only if the individual is a key employee on account of status as a 5-percent owner) in a top-heavy plan.

See, however, the provisions of the bill relating to the extension of the additional income tax to all participants under tax-favored retirement arrangements. For years beginning on or after the effective date of those provisions, the restrictions on rollovers are repealed as deadwood because the additional tax on early withdrawals would apply to distributions from any plan without regard to the recipient's status as a 5-percent owner with respect to the plan making the distribution.

Excess contributions

The bill makes it clear that the repeal by DEFRA of the rule relating to the return of excess contributions made on behalf of a self-employed individual applies with respect to contributions made in taxable years beginning after December 31, 1983.

IRAs, SEPs

The bill conforms the limits on certain distributions of excess IRA contributions and the limits on employer contributions on behalf of certain officers, shareholders, or owner employees to SEPs to the dollar limit on annual additions to a qualified defined contribution plan. This provision is effective as if enacted in TEFRA.

Overall limits

The bill makes it clear that the rule precluding deductions based on anticipated cost-of-living adjustments to the overall benefit limits applies to limit benefits payable as a single life annuity commencing at age 62, as well as benefits paid in alternate forms, those commencing prior to age 62, and those commencing after age 65.

Deduction limits for self-employed individuals

The bill makes it clear that the DEFRA amendment to the definition of earned income did not change the TEFRA definition of earned income for purposes of the 15- or 25-percent limits on deductions (sec. 404). Rather, the change permitting earned income of a self-employed individual to be determined without regard to the deductions allowable for contributions to a qualified plan is to apply solely for purposes of determining the extent to which contributions made to a qualified plan are ordinary and necessary business expenses for purposes of the deduction rules (sec. 404(a)(8)(C)).

This provision is effective as if enacted in TEFRA. The DEFRA amendment, which had the effect of increasing the amount deductible on behalf of a self-employed individual to 15 or 25 percent of earned income before reduction for contributions to the plan on

behalf of the self-employed individual, rather than 15 or 25 percent of earned income after reduction for contributions to the plan on behalf of the self-employed individual, is repealed, effective for taxable years beginning after December 31, 1984.

The bill also clarifies that the deduction available to a self-employed individual for contributions to a qualified plan is not necessarily limited to the cost of actual benefits provided for, or allocations to, the individual. Rather, subject to the usual deduction rules (sec. 404), a self-employed individual is permitted to deduct the allocable share of contributions to a qualified plan. This clarification is effective as if enacted in TEFRA.

Pension withholding

The bill includes distributions of dividends for which the employer is permitted a deduction (sec. 404(k)) in the list of distributions to which the withholding rules do not apply.

Contributions on behalf of disabled individuals

The bill provides that deductible contributions may be continued on behalf of a permanently and totally disabled employee to any defined contribution plan, including a money purchase pension plan.

3. Effective date of provision relating to interest on tentative carrybacks and refund adjustments (sec. 1875(c) of the bill, sec. 6611(f) of the Code and sec. 714(n)(2) of the Act)

Present Law

The Act provided that, for purposes of computing interest on refunds arising from net operating loss carrybacks where a tentative adjustment claim is filed, the refund is treated as filed on the date that the tentative adjustment claim is filed. Prior to this amendment, some taxpayers filed an amended return claiming a refund based on a carryback, waited until the expiration of the 45-day period within which, if a refund is made, no interest is paid, and then filed for a tentative adjustment, which provides for rapid payment. These taxpayers consequently defeated the intent of the interest rules relating to tentative adjustments by obtaining interest on the tentative adjustment relating back to the due date of the return for the year of the loss. The provision of the Act that prevented this misapplication of the intended rules relating to the payment of interest was added to the Act in conference and was effective as if it were included in the Tax Equity and Fiscal Responsibility Act of 1982.

Explanation of Provision

The bill provides that the provision of the Act (sec. 714(n)(2)) relating to interest on tentative carrybacks and refund adjustments is effective only with respect to applications filed after July 18, 1984.

4. Foreign Sales Corporations

a. Treatment of income that a FSC earns without using administrative pricing rules (sec. 1876(a)(1) of the bill and secs. 927 and 1248 of the Code)

Present Law

In general, the Act exempts a fraction of the foreign trade income of a Foreign Sales Corporation (FSC) from tax. The fraction is 15/23 if the FSC uses an administrative pricing rule to determine its income (16/23 if the FSC shareholder is not a corporation). The Act generally denies foreign tax credits for taxes imposed on foreign trade income, but allows a 100-percent dividends received deduction for dividends distributed out of earnings and profits of a FSC that are attributable to that income.

Different rules apply, however, when a FSC does not use the Act's administrative pricing rules. Then, a fraction (generally 30 or 32 percent) of the FSC's foreign trade income is exempt from U.S. tax, and the balance (70 or 68 percent) is so-called "section 923(a)(2) non-exempt income." In general, this section 923(a)(2) non-exempt income is subject to one of three sets of pre-existing rules governing income of foreign corporations generally. It may be taxable currently to the FSC as income effectively connected with a U.S. trade or business. It may be taxable to the FSC's U.S. shareholders under the anti-avoidance rules of subpart F. It may be exempt from current taxation, and taxable only on repatriation to U.S. shareholders.

The Act makes this section 923(a)(2) non-exempt income ineligible for some treatment that it applies to other foreign trade income. For instance, foreign taxes on this income may be creditable, but distributions out of earnings and profits attributable to this income are not eligible for the 100-percent dividends received deduction.

Explanation of Provision

The bill conforms the treatment of effectively connected foreign trade income that a FSC earns without administrative pricing rules (effectively connected section 923(a)(2) non-exempt income) to that of other effectively connected foreign trade income. Taxes on that income are not creditable, but the bill allows a 100-percent dividends received deduction for dividends distributed out of earnings and profits of a FSC that are attributable to that income. That is, this income will be subject to full U.S. tax at the FSC level, but not again at the shareholder level.

b. Treatment of foreign trade income under section 1248 (sec. 1876(a)(2) of the bill and sec. 1248(d)(6) of the Code)

Present Law

Section 1248 treats gain realized by certain U.S. persons on the disposition of stock in a foreign corporation as ordinary income to the extent of allocable earnings and profits. The Act excluded all FSC earnings and profits attributable to foreign trade income from

ordinary income treatment under section 1248, whether or not those earnings would have been eligible for the 100 percent dividends received deduction had the FSC distributed them.

Explanation of Provision

The bill refines the Act's restriction of section 1248 ordinary income treatment on disposition of FSC shares. It provides that FSC earnings and profits that would be taxable on a distribution are subject to ordinary income treatment under section 1248.

c. Clarification of corporate preference cutbacks (sec. 1876 (b) and (i) of the bill and secs. 291, 923, and 995 of the Code)

Present Law

Present law provides for a reduction in certain corporate tax preferences. The Act, in extending this reduction of corporate preferences, sought to reduce the exempt portion of the foreign trade income of a FSC by 1/17 if the shareholder of the FSC is a corporation. The statute indicates that the cutback applies "with respect to" the corporate shareholder of the FSC. Congress intended that the cutback apply at the FSC level, which would reduce the portion of the FSC's foreign trade income that is exempt from tax at that level.

Present law provides a similar reduction in benefits in the case of deferred DISC income. A shareholder of a DISC is treated as having received a distribution taxable as a dividend equal to 1/17 of the excess of the taxable income of the DISC over certain other deemed distributions. The reduction in benefits applies whether or not the shareholder of the DISC is a corporation. Congress intended to limit this cutback to cases where the shareholder of the DISC is a corporation.

Congress intended that the amount of deemed DISC distribution attributable to international boycott activities be computed by multiplying 16/17 of the excess taxable income by the international boycott factor. Present law erroneously indicates that the deemed distribution is computed by multiplying 1/17 of the excess taxable income by the international boycott factor.

Explanation of Provision

The bill clarifies that the FSC preference cutback applies with respect to the FSC, rather than the corporate shareholder of the FSC. The exempt portion of foreign trade income is reduced from 32 to 30 percent in cases in which income is determined without regard to the administrative pricing rules, and from 16 2/3 to 15 2/3 in cases in which income is determined under the administrative pricing rules. The bill also provides that the portion of foreign trade income that is exempt will be adjusted, under regulations, to take into account any shareholders that are not C corporations for whom there is no preference cutback.

The bill also clarifies that the deemed distribution of 1/17 of the excess taxable income of the DISC applies only in the case of a shareholder which is a C corporation. Neither the FSC nor the

DISC corporate preference cutback applies when an S corporation is the shareholder.

In addition, the bill corrects the method for computing the amount of the deemed distribution attributable to international boycott activities. This amount is computed by multiplying $16/17$ of the excess taxable income by the international boycott factor.

d. Treatment of foreign trade income under subpart F (sec. 1876(c) of the bill and secs. 951 and 952 of the Code)

Present Law

The Act contains a sentence designed to prevent shareholder level taxation under Subpart F's anti-avoidance rules of income already taxed at the FSC level. That sentence appears in a Code provision designed to prevent shareholder level taxation of earnings and profits attributable to most foreign trade income, whether or not taxed at the FSC level.

Explanation of Provision

The bill makes it clear that there is to be no shareholder level taxation under Subpart F's anti-avoidance rules of income already taxed at the FSC level.

e. Dividends received deduction for certain distributions from a FSC (secs. 1876(d)(1) and 1576(j) of the bill and sec. 245 of the Code)

Present Law

Present and prior law allow an 85-percent dividends received deduction for dividends received from a foreign corporation if half or more of the foreign corporation's gross income (over a 3-year period) is effectively connected with the conduct of a U.S. trade or business. This 85-percent deduction applies, on a pro rata basis, to the extent that the foreign corporation's gross income is effectively connected income.

The Act treats all interest, dividends, royalties, and other investment income received or accrued by a FSC as income effectively connected with a trade or business conducted through a permanent establishment in the United States. If enough of a FSC's income is effectively connected, the FSC will meet the 50-percent of gross income test that will qualify its U.S. corporate shareholders for the 85-percent dividends received deduction for dividends attributable to this passive income. If the FSC does not meet the 50-percent of gross income test, however, then none of its dividends attributable to passive income will be eligible for the 85-percent dividends received deduction. Whether the FSC meets the 50-percent of gross income test depends on a number of factors.

The Act also provides a 100-percent dividends received deduction for distributions out of earnings and profits attributable to foreign trade income of a FSC other than section 923(a)(2) non-exempt income.

Explanation of Provision

In general, the bill provides an 85-percent dividends received deduction for any dividend received by a U.S. corporation from a FSC that is distributed out of earnings and profits attributable to "qualified interest and carrying charges." Qualified interest and carrying charges mean interest or carrying charges derived from a transaction that results in foreign trade income. Passive income that is not directly related to foreign trade income is not eligible for this treatment.

In addition, the bill specifies that gross income giving rise to earnings and profits attributable to foreign trade income or to qualified interest and carrying charges of a FSC will not be taken into account for purposes of calculating a dividends received deduction under the general rules (with respect to other income of the FSC). Thus, for example, such income will not be taken into account in determining whether a dividend attributable to such other income allows a dividends received deduction because half or more of the FSC's gross income is effectively connected with a U.S. trade or business.

f. Separate foreign tax credit limitation for FSC income (sec. 1876(d)(2) of the bill and sec. 904 of the Code)

Present Law

Distributions from a FSC or former FSC out of earnings and profits attributable to foreign trade income are subject to a separate foreign tax credit limitation.

Explanation of Provision

Under the bill, distributions from a FSC or former FSC out of earnings and profits attributable to foreign trade income or qualifying interest and carrying charges are subject to a separate foreign tax credit limitation. The purpose of this provision is to prevent this income from absorbing foreign tax credits from other income, and to prevent other income from absorbing foreign tax credits (if any are allowable) on this income.

g. Coordination of foreign tax credit for foreign corporations and deemed paid credit (sec. 1876(d)(3) of the bill and secs. 902 and 906 of the Code)

Present Law

A foreign corporation may credit foreign taxes imposed on income that is effectively connected with the conduct of a trade or business in the United States (sec. 906). A corporate U.S. shareholder owning 10 percent or more of the voting stock of a foreign corporation may be eligible for a deemed paid foreign tax credit when the corporation pays a dividend (sec. 902). This deemed paid credit allows such a U.S. shareholder to credit again the taxes that the foreign corporation paid. If enough of the foreign corporation's income is effectively connected, its U.S. shareholders may be eligible for a dividends received deduction for the dividends the foreign corporation pays them.

The Act makes all investment income of a FSC effectively connected income. It generally makes the taxable portion of foreign trade income of a FSC effectively connected income.

Explanation of Provision

The bill provides that taxes paid or accrued with respect to, and accumulated profits attributable to, income of a foreign corporation that is effectively connected with the conduct of a trade or business within the United States shall not be taken into account for purposes of the deemed paid credit. This provision is designed to prevent a double tax benefit.

h. Exchange of information requirements (sec. 1876(e) of the bill and sec. 927(e)(3) of the Code)

Present Law

A corporation (other than a corporation formed in an eligible U.S. possession) cannot qualify as a FSC unless there was in effect, at the time of creation or organization of the FSC, with the foreign country under whose laws it was created or organized, either (1) an agreement allowing tax benefits under the Caribbean Basin Initiative, or (2) an income tax treaty with respect to which the Secretary of the Treasury certifies that the exchange of information program with respect to the country carries out the purposes of paragraph 927(e)(3) of the Code. The purposes of that paragraph are not specified in the statute. An agreement under the Caribbean Basin Initiative must generally provide for disclosure for civil tax purposes of information that is otherwise confidential under local law, but may provide for nondisclosure of such information if the President determines that the agreement as negotiated is in the national security interest of the United States.

A FSC (other than a small FSC) must maintain its principal bank account outside the United States at all times during the taxable year.

Explanation of Provision

The bill provides that a corporation cannot continue to qualify as a FSC if its country of incorporation, having once qualified as a host country for FSCs, ceases to qualify. Notwithstanding a Treasury determination that a country ceases to qualify, under Treasury regulations, corporations established in that country continue to be eligible for FSC benefits for the six months following the determination.

The bill also makes it clear that a country may qualify as a host country for FSCs by entering into an exchange of information agreement of the type that allows tax benefits under the Caribbean Basin Initiative, whether or not that country is eligible to be a beneficiary of the Caribbean Basin Initiative. The bill also specifies that the national security exception under the Caribbean Basin Initiative will not apply for purposes of FSC; thus, to be acceptable for FSC purposes, an exchange of information agreement must require disclosure of confidential information.

The bill also makes it clear that an income tax treaty will allow a country to qualify as a host country for FSCs only if the Secretary certifies that its exchange of information program is satisfactory in practice for purposes of the Internal Revenue Code. That is, the program should provide to the United States in practice such information as may be relevant to the determination of a U.S. tax liability or whether a tax-related criminal offense has been committed.

In addition, the bill makes it clear that, for a corporation to qualify as a FSC, the exchange of information program of the country of its incorporation must cover that particular corporation. The bill makes it clear, for example, that a corporation incorporated in a treaty partner country but not subject to the exchange of information program of the treaty because it is not resident in the treaty partner does not qualify for FSC status.

The bill makes it clear that a FSC (other than a small FSC) must maintain its principal bank account in a possession of the United States or in a country that qualifies as a host country for FSCs at all times during the taxable year. This requirement is effective for periods after March 28, 1985.

i. Coordination with possessions taxation (sec. 1876(f) of the bill and sec. 927(e)(5) of the Code)

Present Law

Under present law, a possession of the United States may not impose a tax on any foreign trade income of a FSC that is derived before January 1, 1987. Foreign trade income is generally the gross income of a FSC attributable to the sale or lease of export property outside the United States. Thus, foreign trade income may be derived from the sale or lease of export property (or performance of services) within a U.S. possession by a FSC located in the possession. Congress intended, with respect to any foreign trade income or passive income of a FSC that a possession is permitted to tax, that the possession would also be permitted to exempt such income from tax. In some cases, U.S. tax imposed on certain income connected with a possession is covered over to the possession.

Explanation of Provision

The bill provides that a U.S. possession is not prohibited from imposing a tax on any income attributable to the sale of property or the performance of services for use, consumption or disposition within the possession. Thus, for example, the Virgin Islands is not prohibited from imposing a tax on the income derived from the sale of goods by a U.S. company, through its FSC located in the Virgin Islands, to customers in the Virgin Islands.

The bill clarifies that no provision of law may be construed as prohibiting a U.S. possession from exempting from tax any foreign trade income or passive income (e.g., interest, dividends or carrying charges) of a FSC. The bill also clarifies that no provision of law may be construed as requiring any income tax imposed by the United States on a FSC to be covered over (or otherwise transferred) to any U.S. possession.

j. Interest on DISC-related deferred tax liability (sec. 1876(g) of the bill and sec. 995(f) of the Code)

Present Law

A DISC may defer income attributable to $10 million or less of qualified export receipts. However, an interest charge is imposed on the shareholders of the DISC. The amount of the interest is based on the tax otherwise due on the deferred income, computed as if the income were distributed.

Explanation of Provision

The bill clarifies that an interest charge is to be imposed on the deferred income of a former DISC in the same manner that it is imposed on a DISC.

k. Exemption of accumulated DISC income (sec. 1876(h) of the bill and sec. 805(b)(2) of the Act)

Present Law

Accumulated DISC income which is derived before January 1, 1985 is generally exempt from tax. This result is achieved by treating actual distributions made after December 31, 1984 by a DISC (or former DISC which was a DISC on December 31, 1984) as previously taxed income with respect to which there had previously been a deemed distribution. It is unclear under present law whether a distribution in liquidation is an "actual distribution" for purposes of this provision. It is also unclear how such a distribution would be treated for purposes of computing the earnings and profits of any corporate shareholder of the DISC.

Explanation of Provision

The bill clarifies that for purposes of exempting from tax accumulated DISC income, the term actual distribution includes a distribution in liquidation. The bill further clarifies that the earnings and profits of any corporation receiving a distribution that is not included in gross income because it is treated as previously taxed income under this provision will be increased by the amount of the distribution.

l. Effective date of tax year conformity requirement (sec. 1876(i) of the bill and sec. 805(a)(4) of the Act)

Present Law

In general, the taxable year of any DISC must be the taxable year of its owner. If the DISC has more than one shareholder, the taxable year of shareholders with a plurality of voting power controls. This rule applies to any DISC established after March 21, 1984.

Explanation of Provision

The bill provides that the rule requiring conformity of tax years applies to taxable years beginning after December 31, 1984. The

bill makes it clear that this rule will apply to interest-charge DISCs, whether or not newly formed.

m. Treatment of certain qualifying distributions from a DISC (sec. 1876(k) of the bill and sec. 996 of the Code)

Present Law

To qualify as a DISC, 95 percent of a corporation's gross receipts must be "qualified export receipts." If a corporation seeking to qualify as a DISC does not meet that 95-percent test for a year, it may, after that year's close, qualify retroactively by distributing to its shareholders property in an amount equal to taxable income attributable to gross receipts that are not qualified export receipts. Generally, under prior law, one-half of this kind of distribution to meet qualification requirements was treated as coming out of accumulated DISC income, and one-half was treated as coming out of previously taxed income. Under prior law, generally, one-half of a DISC's income was deemed distributed to its shareholders. The treatment of a distribution to meet qualification requirements was based on the notion that one-half of a DISC's taxable income attributable to all gross receipts had already been taxed as a deemed distribution, while the other half was deferred. Under the Act, one-seventeenth of a DISC's income is deemed distributed to shareholders that are C corporations.

Explanation of Provision

In the case of a shareholder that is a C corporation, the bill would treat $^{16}/_{17}$ of a DISC's distribution to meet the qualified export receipts requirement as coming out of accumulated DISC income, with generally only $^{1}/_{17}$ coming out of previously taxed income. This treatment reflects the post-1984 treatment of DISC income attributable to a shareholder that is a C corporation, whereunder only $^{1}/_{17}$ is deemed distributed and taxed currently.

n. Treatment of certain receipts from another FSC (sec. 1876(l) of the bill and sec. 924 of the Code)

Present Law

A FSC cannot treat as foreign trading gross receipts any receipts from another FSC that is a member of the same controlled group (Code sec. 924(f)(1)). The prohibition of sales through related FSCs prevents pyramiding of benefits under the gross receipts method of calculating income.

Explanation of Provision

The bill permits FSCs to treat receipts from another FSC that is a member of the same controlled group as foreign trading gross receipts, if no FSC in the group uses the gross receipts method of calculating income.

o. Treatment of certain former export trade corporations (sec. 1876(m) of the bill and sec. 805(b) of the Act)

Present Law

The Act provides that accumulated DISC income, in certain circumstances, will not be subject to U.S. tax. Similarly, the Act provides that certain income of active export trade corporations (as defined in Code sec. 971) will not be subject to U.S. tax, but only if the export trade corporation either elects to be treated as a FSC or surrenders its export trade corporation status.

Explanation of Provision

The bill extends to corporations that had been export trade corporations at some point but that were not export trade corporations for their most recent taxable years ending before July 18, 1984, the same treatment that the Act extended to active export trade corporations. To qualify for this treatment, a former export trade corporation either must be precluded (under statutory rules) from again qualifying as an export trade corporation, or must elect never again to qualify as such.

p. Distributions of accumulated DISC income received by cooperatives (sec. 1876(n) of the bill and sec. 805(b)(2) of the Act)

Present Law

The Act excludes from gross income certain distributions of accumulated DISC income. That exclusion applies to certain accumulated DISC income received by certain cooperative organizations.

Explanation of Provision

The bill provides that amounts excluded from the gross income of a cooperative organization described in Code section 1381 by sec. 805(b)(2)(A) of the Act will not be included in the gross income of the cooperative's members when distributed to them. Distributions arising from tax-free accumulated DISC income will not be deductible by the cooperative organization. This treatment reflects the concept that a cooperative organization is a flow-through entity analogous to a partnership for the purpose of the exclusion of certain accumulated DISC income from tax.

5. Excise tax refund for diesel fuel used in school buses (sec. 1877(b) of the bill and sec. 6427(b) of the Code)

Present Law

The Act allows a complete refund of the 15-cents-a-gallon excise tax paid on diesel fuel which is used by private contractors to provide scheduled local bus service to the general public over regular routes, because the service substitutes for publicly provided service that would use tax-exempt fuel. However, the Act failed to provide a complete refund when private contractors supply school bus service, the diesel fuel for which would be tax-exempt if the service were supplied by a State or local government or nonprofit school.

The effective excise tax rate on this fuel is 3 cents a gallon (tax of 15 cents a gallon, less refund of 12 cents a gallon), the effective rate that generally applies to diesel fuel used in privately operated buses.

Explanation of Provision

The bill allows a full 15-cents-a-gallon refund of excise tax on diesel fuel used in a school bus while engaged in the transportation of students and school employees.

6. Certain helicopter uses exempt from aviation excise taxes (sec. 1878(c) of the bill and secs. 4041 and 4261 of the Code)

Present Law

The Act expands the exemptions from the aviation excise taxes previously provided with respect to helicopters engaged in qualified timber and hard mineral resource activities where no FAA navigational facilities or airport are used to include helicopters engaged in qualified oil and gas activities.

Explanation of Provision

The bill clarifies that the exemptions for oil and gas activities are coterminous with those previously provided for hard mineral resource activities. Therefore, helicopters engaged in the exploration for, or the development or removal of, oil and gas will be exempt from the aviation excise taxes, provided the helicopters do not use Federally aided airports or Federal airway facilities.

7. Acquisition indebtedness of certain exempt organizations (sec. 1878(d) of the bill and sec. 514(c)(9) of the Code)

Present Law

The Act provided rules excepting certain debt-financed real estate held by qualified pension trusts and educational institutions from the unrelated business income tax. In the case where the exempt organization is a partner in a partnership (along with taxable entities), the Act provided that each allocation to the exempt organization be a qualified allocation, within the meaning of the tax-exempt entity leasing rules of section 168(j)(9).

Explanation of Provision

The bill provides that the Secretary may treat the qualified allocation rule as met if it is shown to the satisfaction of the Secretary that there is no potential for tax avoidance. For example, if the partnership elects 40-year straight-line depreciation on leased real estate and if the failure to meet the qualification allocation rule is caused by the allocation of an increased share of a loss or deduction to the exempt organization in order to meet the substantial economic effect requirement of section 704(b)(2), it is expected that the Secretary would treat the new rule as having been met.

8. Military housing rollover (sec. 1878(f) of the bill and sec. 1034(h)(2) of the Code)

Present Law

The Act provides an extended nonrecognition period for rollover of gain on sale of a personal residence in the case of military personnel stationed outside the United States, or required to reside in government quarters at certain remote base sites within the United States. In such a case, the nonrecognition rollover period otherwise allowable under Code section 1034(h)(1) is not to expire until the last day on which the person is stationed outside the United States or is required to reside in government quarters at a remote base site within the United States, except that this extended nonrecognition period cannot exceed eight years after the date of the sale of the old residence. This provision applies to sales of old residences occurring after July 18, 1984.

Explanation of Provision

The extended nonrecognition period under Code section 1034(h)(2) is not to expire before the day which is one year after the last day on which the taxpayer is stationed outside the United States or is required to reside in government quarters at a remote base site within the United States, except that this extended nonrecognition period cannot exceed eight years after the date of the sale of the old residence. This modification conforms the provision to the Senate amendment, which was adopted by the conference committee on the 1984 Act.

9. Effective date for disallowance of deduction for costs of demolishing structures (sec. 1878(g) of the bill and sec. 280B of the Code)

Present Law

Costs and other losses incurred in connection with the demolition of buildings must be added to the basis of the land on which the demolished buildings were located in all cases, rather than claimed as a current deduction. Before enactment of the Act, this rule applied only to certified historic structures. The expanded provision is effective for taxable years beginning after December 31, 1983.

Explanation of Provision

The bill clarifies that the expanded prohibition on current deduction of costs and other losses incurred in connection with demolition applies only to demolitions commencing after July 18, 1984, in the case of buildings other than certified historic structures. For this purpose, if a demolition is delayed until the completion of the replacement structure on the same site, the demolition shall be treated as commencing when construction of the replacement structure commences.

The bill also allows the unrecognized basis in specified demolished structures to be allowed as an ordinary deduction in the year of demolition.

A transitional rule is provided in a specified case where plans for the demolition were in place on July 18, 1984.

10. Regulated investment companies (sec. 1878(i) of the bill and sec. 852 of the Code)

Present Law

All regulated investment companies (RICs) are required to comply with regulations prescribed by the Treasury for the purpose of ascertaining its stock ownership (sec. 852(a)(2)). Under present law, as modified by the Act, a personal holding company may be eligible to be a RIC. The Act provided that any investment company taxable income of a RIC that is a personal holding company is taxed at the highest rate applicable to corporations.

Explanation of Provision

The provisions of the Act that permitted personal holding companies to qualify as RICs eliminated the necessity for a RIC to keep shareholder records that were intended to assure that it was not a personal holding company and thereby could qualify as a RIC. Accordingly, the bill eliminates the requirement that adequate shareholder records must be kept in order for a corporation to qualify as a RIC. Nevertheless, the bill provides that the investment company taxable income of a RIC that does not keep such records would be subject to tax at the highest corporate rate, since such treatment is provided for RICs that are personal holding companies.

11. Waiver of estimated tax penalties (sec. 1879(a) of the bill)

Present Law

Under present law, if the withholding of income taxes from wages does not cover an individual's total income tax liability, the individual, in general, is required to file estimated tax returns and make estimated tax payments. Also, corporations are normally required to make quarterly estimated tax payments. An underpayment of an estimated tax installment will, unless certain exceptions are applicable, result in the imposition of an addition to tax on the amount of underpayment for the period of underpayment (secs. 6654 and 6655, with the rate as determined under sec. 6621).

The Act, enacted on July 18, 1984, made several changes which increased tax liabilities from the beginning of 1984.

Explanation of Provision

The bill allows individual taxpayers until April 15, 1985, and corporations until March 15, 1985 (the final filing dates for calendar year returns) to pay their full 1984 income tax liabilities without incurring any additions to tax on account of underpayments of estimated tax to the extent that the underpayments are attributable to changes in the law made by the Tax Reform Act of 1984.

In order to minimize any administrative problems to the Internal Revenue Service, it will be expected that taxpayers notify the IRS if they are entitled to the benefits of this provision. The IRS will

not be required to notify taxpayers of possible relief under this provision.

12. Orphan drug credit (sec. 1879(b) of the bill and sec. 28 of the Code)

Present Law

A 50-percent tax credit is available for qualified clinical testing expenses that are necessary to obtain the approval of the Food and Drug Administration for the commercial sale of a drug for a rare disease. The term "clinical testing" is defined, in part, by reference to the date on which an application with respect to a drug is approved under section 505(b) of the Federal Food, Drug, and Cosmetic Act. The term "rare disease or condition" is defined as any disease or condition that occurs so infrequently in the United States that the taxpayer has no reasonable expectation of recovering the cost of developing and marketing a drug for such disease from sales in the United States.

Explanation of Provision

The bill clarifies that, in the case of a drug that is a biological product, "clinical testing" is defined, in part, by reference to the date on which a license for such drug is issued under section 351 of the Public Health Services Act. The bill also redefines the term "rare disease or condition" as any disease that (1) affects less than 200,000 persons in the United States, or (2) affects more than 200,000 persons in the United States but for which there is no reasonable expectation that the cost of developing and making available a drug for such disease in the United States will be recovered from sales of such drug in the United States. This will conform the provisions of the tax credit with the provisions of the Federal Food, Drug, and Cosmetic Act.

The amendments apply to amounts paid or incurred after December 31, 1982.

13. Credit for producing fuel from nonconventional source (sec. 1879(c) of the bill and sec. 29 of the Code)

Present Law

Present law provides a credit for certain fuels produced by a taxpayer and sold to an unrelated party.

Explanation of Provision

The bill provides that the credit may be allowed where the sale to an unrelated person is made by a corporation which files a consolidated return with the corporation producing the fuel. The provision applies as if included in section 231 of the Crude Oil Windfall Profit Tax Act of 1980.

14. Report of refunds by Joint Committee to Congress (sec. 1879(e) of the bill and sec. 6405(b) of the Code)

Present Law

The Code (sec. 6405(b)) requires the Joint Committee on Taxation to make an annual report to Congress setting forth the proposed tax refunds and credits submitted by the Internal Revenue Service to the Joint Committee for its review, including the names of the taxpayers and amounts involved. It is unclear whether this requirement was overridden by the tax return disclosure limitations (sec. 6103) enacted in 1976. Because of this apparent conflict, these reports have not been submitted in recent years and the Joint Committee believes it appropriate to delete the requirement to submit this report.

Explanation of Provision

The bill repeals the requirement that the Joint Committee on Taxation submit an annual report to Congress on proposed IRS tax refunds and credits.

15. Rural electric cooperative cash or deferred arrangements (sec. 1879 of the bill and sec. 401(k) of the Code)

Present Law

Under the Code, gross income may include amounts actually or constructively received as income. For example, under the rules of constructive receipt, the gross income of an individual includes compensation that has been earned and that would have been received but for the individual's election to defer its receipt. The Code provides for an exception to the rules of constructive receipt in the case of employer contributions under a qualified cash or deferred arrangement.

If a tax-qualified profit-sharing or stock bonus plan (or certain pre-ERISA money purchase pension plans) meets certain requirements (a qualified cash or deferred arrangement), then an employee is not required to include in income any employer contributions to the plan merely because the employee could have elected to receive the amount contributed in cash.

Because a qualified stock bonus plan is generally required to distribute benefits in the form of employer stock, a qualified stock bonus plan may not be maintained by a governmental unit or by a tax-exempt membership organization. Under the Code, employer contributions to a qualified profit-sharing plan may be made only from preset or accumulated employer profits.

It is unclear under present law whether an employer that is a governmental entity or a tax-exempt organization may maintain a qualified cash or deferred arrangement because such an organization may not have stock or profits in the usual sense of those terms.

Explanation of Provision

The bill clarifies that any organization that is exempt from tax and that is engaged primarily in providing electric service on a mutual or cooperative basis is eligible to maintain a qualified cash or deferred arrangement. This provision also applies to a national association of such tax-exempt organizations.

16. Definition of newly discovered oil (sec. 1879(h) of the bill and sec. 4991 of the Code)

Present Law

Under the present law, the windfall profit tax is imposed at a lower rate on newly discovered oil than on other oil. Generally, the term "newly discovered oil" has the meaning given to it by the June 1979 energy regulations.

The legislative history to the Crude Oil Windfall Profit Tax Act of 1980 indicates that the term was also to include production from a property which did not produce oil in commercial quantities during calendar year 1978. That history indicates that it includes production from a property on which oil was produced in 1978 if that production was incident to the drilling of exploratory or test wells and was not part of continuous or commercial production from the property during 1978.

Explanation of Provision

The bill clarifies that the term "newly discovered oil" includes production from a property so long as not more than 2200 barrels was produced from the property in 1978 and no well on the property was in production for more than 3 days during that year (whether or not the oil was sold). This provision is intended to clarify the "test well" exception described in the Conference Report accompanying the Crude Oil Windfall Profit Tax Act of 1980. No inference is intended as to the application of similar principles in areas other than section 4991(e)(2).

17. Allowance of investment tax credit to members of certain tax-exempt religious organizations (sec. 1879(i) of the bill and sec. 48 of the Code)

Present Law

Present law provides an income tax exemption for a religious or apostolic association or corporation if (1) it has a common treasury or community treasury, even if it engages in business for the common benefit of the members, and (2) its members include (at the time of filing their returns) in their gross income their entire pro rata shares, whether distributed or not, of the organization's taxable income for such year (sec. 501(d)). Any amount so included in the gross income of a member is treated as a dividend received. Thus, members of section 501(d) organizations file individual tax returns and pay income tax on their pro rata shares of organization income.

The Code allows an investment tax credit for certain acquisitions of depreciable property (sec. 38(a)). In the case of such property used by a tax-exempt organization, however, the credit is not allowed unless the property is used in an unrelated trade or business the income of which is subject to tax under section 511 (sec. 48(a)(4)). The Ninth Circuit has ruled that since section 501(d) organizations are not subject to the section 511 tax on unrelated business taxable income, neither the organization nor its members on their tax returns can claim the investment tax credit for depreciable property acquired by the organization (*Kleinsasser v. U.S.*, 707 F.2d 1024 (9th Cir. 1983)).

Explanation of Provision

The bill provides that, for purposes only of the investment credit rules in section 48(a)(4), any business which is conducted by an eligible section 501(d) organization for the common benefit of its members and the taxable income from which is included in the gross income of its members is to be treated as an unrelated business. Accordingly, the acquisition of depreciable property by an eligible section 501(d) organization for use in such a business gives rise to an investment tax credit to the same extent as if the property had been acquired by a section 501(c)(3) organization for use in an unrelated business.

Under the provision, the amount of such qualified investment by a section 501(d) organization is apportioned pro rata among its members in the same manner as its taxable income is allocated. The bill does not allow any credit for such investment to a member who claimed any other type of investment credit, and prohibits the reallocation of any such disallowed credit to other community members. The used-property credit limitation and credit recapture rules apply at the organization level.

The provisions apply to any organization which elects to be treated as an organization described in section 501(d) and which is exempt from tax under section 501(a), and which does not provide a substantially higher standard of living for any person or persons than it does for the majority of the members of the community.

The provision applies to periods after 1978 (under rules similar to those in Code sec. 48(m)).

18. Mutual savings banks (sec. 1879(j) of the bill and sec. 501(c)(14) of the Code)

Present Law

The Economic Recovery Tax Act (ERTA) provided that a stock association which is subject to the same regulation as a mutual savings bank is treated as a mutual savings bank and thus eligible to compute its bad debt deduction under section 593.

Explanation of Provision

The bill provides that a stock association which is treated as a mutual savings bank for purposes of computing a bad debt deduction is also treated as a mutual savings bank for purposes of the

exemption for mutual organizations insuring these banks (sec. 501(c)(14)(B)). The provision is effective as if enacted in ERTA.

19. Reorganization of investment companies (sec. 1879(k) of the bill and sec. 368(a)(2)(F) of the Code)

Present Law

The Tax Reform Act of 1976 prevented the tax-free reorganization of certain investment companies. Exceptions were applied for stock in RICs, REITs and diversified investment companies.

Explanation of Provision

The bill provides that the stock of a RIC, REIT or diversified investment company will not be treated as stock of a single issuer for purposes of determining whether the holder is diversified within the meaning of section 368(a)(2)(F)(ii). This provision is intended to permit an investment company to be treated as a diversified investment company only if it would be so defined if it were deemed to own its ratable share of the assets of any RIC, REIT, or diversified investment company in which it owns stock (without regard to whether its percentage ownership is 50 percent or more). The provision will be effective as if included in the Tax Reform Act of 1976.

20. Subchapter S amendments (sec. 1879(l) of the bill and secs. 1361 and 1368 of the Code)

The Subchapter S Revision Act of 1982 revised the treatment of S corporations. Rules were provided allowing certain trusts as shareholders and also rules were provided for the tax-free distributions of subchapter S earnings.

Explanation of Provision

The bill provides that shares which are treated as separate trusts for purposes of section 663(c) are also treated as separate trusts for purposes of the rules relating to qualified subchapter S trusts (sec. 1361(d)(3)).

The bill also provides that the accumulated adjustments accounts (which measures the amount of subchapter S earnings which may be distributed tax-free) will not be reduced by reason of federal taxes arising while the corporation was a C corporation.

These provisions will apply to taxable years beginning after December 31, 1982.

21. Windfall profit tax (sec. 1879(n) of the bill and sec. 4991 of the Code)

The windfall profit tax provides an exemption for oil held by certain charitable organizations.

Explanation of Provision

The bill provides that the exemption for "qualified charitable interests" includes an interest held by the Episcopal Royalty Company.

22. Qualified terminable interest property (sec. 1879(m)) of the bill and sec. 2523 of the Code)

Present Law

Present law allows a gift tax deduction for gifts of certain life estates made to a donee spouse. The election must be made by April 15 after the calendar year the interest in transferred.

Explanation of Provision

The bill provides that this election must be made on or before the date, including extensions, prescribed by section 6075 for filing a gift tax return with respect to the year in which the transfer was made.

23. Clerical amendments

The bill contains numerous minor clerical, typographical and conforming amendments.

H. Effective Dates

Except as otherwise described, the amendments made by the Technical Corrections title to the tax provisions will take effect as if included in the original legislation to which each amendment relates.

I. Revenue Effect

The amendments made by the Technical Corrections title to the bill are estimated to reduce fiscal year budget receipts by $389 million in 1987, and $127 million in 1988, to increase fiscal year budget receipts by $5 million in 1989, and $3 million in 1990, and to decrease receipts by $7 million in 1991.

TECHNICAL CORRECTIONS IN OTHER PROGRAMS AFFECTED BY THE DEFICIT REDUCTION ACT OF 1984

A. Technical Corrections to Social Security Program

1. Special Social Security Treatment for Church Employees (sec. 1882 of the bill, sec. 2603 of the Act, secs. 1402 and 3121 of the Code and sec. 211 of the Social Security Act)

a. Application to members of certain religious faiths

Present Law

The Act allows a church or qualifying church-controlled organization to make a one-time election to exclude from the definition of employment, for purposes of FICA taxes, services performed in the employ of the church or organization. If an election is made to exclude services for FICA purposes, the employee is treated similarly to a self-employed person with respect to those services. Thus, the employee is liable for self-employment ("SECA") taxes on remuneration for such services. The amount of remuneration on which an employee of an electing organization is liable for SECA tax is generally the same as the amount which would have been subject to FICA tax in the absence of an election.

Under section 1402(g) of the Code, an exemption from SECA taxes is provided for self-employed members of a religious sect (e.g., the Amish) who are adherents of established tenets or teachings of that sect, by reason of which such individuals are conscientiously opposed to public or private death, retirement, or medical insurance (including social security). This exemption is not available to employees. This exemption is granted only upon application by the individual, which must include evidence of the sect's tenets or teachings and of the individual's adherence to them. To obtain an exemption, the individual must waive all social security benefits.

Explanation of Provision

The bill makes clear that the exception from SECA taxes for members of certain religious faiths (sec. 1402(g)) is not available for services with respect to which SECA tax is due as a result of an election under the Act. Thus, if a member of a religious faith covered by the sec. 1402(g) exception is an employee of a church or church-controlled organization, and that church or organization elects to treat the employee as self-employed for FICA tax purposes, the employee cannot also claim a section 1402(g) exception from SECA taxes with respect to those services. This provision prevents the combination of an election under the Act, and a section 1402(g) exception, from resulting in an avoidance of any employment taxes on the services performed for the electing organization. This is consistent with the general principle that the tax for serv-

ices covered by an election should be determined (to the extent possible) as it would be under FICA, for which the section 1402(g) exception would be unavailable. The provision does not affect the individual's ability to claim a section 1402(g) exception with respect to other services not covered by an election under the Act.

b. Computation of income subject to SECA tax

Present Law

Under the Act, the remuneration on which the employee of an electing church or organization is liable for SECA tax generally is the same as the amount which would have been subject to FICA tax if that individual had continued to be treated as an employee. Thus, trade or business expenses are not subtracted in computing self-employment income (reimbursed business expenses are not included in self-employment income, however), and the $400 threshold generally applicable to self-employment income does not apply. Similarly, a $100 threshold (per employer) for a taxable year applies in determining whether remuneration for services covered by an election is subject to SECA tax. However, after 1989 these employees will be eligible for a deduction, in computing SECA taxes, for the product of net earnings from self-employment and one-half of the SECA rate.

Explanation of Provision

The bill provides several changes to insure that church employee income will be determined, as far as possible, using FICA principles, and that the taxation of other self-employment income will not be affected by an election. Specifically, the bill specifies that the SECA tax base for services covered by an election is to be computed in a separate "basket" from the tax base for other self-employment income. Thus, church employee income is not reduced by any deduction, while other income and deductions are not affected by items attributable to church employee income.[15] (This rule does not apply to the deduction for the product of all net self-employment earnings and one-half the SECA tax rate, beginning after 1989). Additionally, the $100 threshold for taxing church employee income, and the $400 threshold applicable to other self-employment income, are separately applied under the bill (i.e., church employee income does not count toward the general $400 threshold).

This provision is effective only for remuneration paid or derived in taxable years beginning on or after January 1, 1986.

c. Voluntary revocation of election

Present Law

Under the Act, a church or organization must make an election to treat services performed for the church or organization as subject to SECA (rather than FICA) taxes before its first quarterly employment tax return is due, or if later, 90 days after July 18, 1984.

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[15] The "optional" method of computing self-employment income applies only to non-church employee income.

Once made, that election may not be revoked by the church or organization. However, an election is to be permanently revoked by the Treasury Department if the electing church or organization fails to provide required information regarding its employees for a period of two years or more and, upon request by the Treasury Department, fails to furnish previously unfurnished information for the period covered by the election. (This information is required in order to monitor compliance with the provisions of the Act.) This rule could allow an electing church or organization effectively to revoke its election by failing to provide the required information.

Explanation of Provision

The bill allows a church or organization to revoke an election under regulations to be prescribed by the Treasury Department. The bill does not amend the present-law rules allowing the Treasury Department to revoke an election for failure to provide required information. A church or organization which revokes an election (or for which the election is revoked) cannot make another election, because the time for making such an election has lapsed.

2. Miscellaneous Corrections (sec. 1883 of the bill)

The bill makes certain corrections in spelling, language, and indentation provisions related to Social Security Act programs.

B. Technical Corrections to AFDC and Child Support Programs

1. Disregard of Income of a Stepparent (sec. 1883(b)(1)(A) of the bill)

Present Law

The AFDC plan requirement pertaining to the treatment of earned income of a stepparent allows a monthly disregard of $75 (in recognition of work expenses). Current law allows the Secretary to prescribe the disregard or a lesser amount for individuals not in full-time employment or not employed throughout the month.

Explanation of Provision

The bill deletes the Secretary's authority for the disregard of a lesser amount in the case of earnings of a stepfather, since the Deficit Reduction Act deleted the comparable authority for the general income disregard provision of section 402(a)(8) of the Act.

This provision is effective October 1, 1984, the effective date of the Deficit Reduction Act amendment to section 402(a)(8).

2. Family Unit Rule (sec. 1883(b)(2)(A) of the bill

Present Law

Section 402(a)(38) of the Social Security Act requires the inclusion in the AFDC family unit of all parents of the dependent child, and all siblings who are themselves dependent children.

Explanation of Provision

The bill clarifies that a sibling is to be included in the AFDC family unit who is deprived of parental support or care by reason of the unemployment of a parent (and meets the other criteria of a dependent child) as well as one who is deprived by reason of the death, absence, or incapacity of a parent. No such distinction between these two categories was intended, and this provision will clarify that, in a State that provides AFDC on the basis of the unemployment of a parent, siblings who are dependent children for that reason must be included in the AFDC unit.

This provision is effective October 1, 1984, the date that paragraph (38) was added to section 402(a) of the Act.

3. Income of AFDC Family Unit (sec. 1883(b)(2)(B) of the bill)

Present Law

Section 402(a)(38) of the Social Security Act requires that, in determining the eligibility and benefit amount of the AFDC family unit, all income of family members must be included. Specific reference is made to OASDI benefits paid under title II of the Act.

Explanation of Provision

The bill makes clear that title II benefits, along with income from all other sources, are to be included by the State agency in determining AFDC eligibility and benefits. The provision also clarifies that counting these benefits in this way will not be considered to violate section 208(e). That section makes it a crime, under the general title II rules, for a payee to use the OASDI payments for someone other than the beneficiary. Therefore, this provision clarifies that that latter section is inapplicable to the inclusion of such benefits in the AFDC family's income.

The bill also makes clear that support payments, regardless of the terms of the payer's obligation under State law, must be included as part of the total income available to the family. (This is the same result that occurs when AFDC is paid to the family for a month and the child support agency subsequently collects support on behalf of one or more family members and then reimburses the AFDC agency for assistance already provided.)

This provision is effective October 1, 1984, the date that paragraph (38) was added to the Social Security Act.

4. Clerical Correction Relating to Income of AFDC Family Unit (sec. 1883(b)(2)(C) of the bill)

Explanation of Provision

The bill corrects the indentation and placement of a portion of section 402(a)(38) of the Social Security Act. The provision is effective October 1, 1984, the date that paragraph (38) was added to the Act.

5. Income of a Minor AFDC Parent (sec. 1883(b)(3) of the bill)

Present Law

Section 402(a)(39) of the Social Security Act requires, that in determining the income of a minor parent (of an AFDC child) who is living with her own parents or legal guardian, the State agency must include the income of the parents or legal guardian. In deciding what age defines "minor" for this purpose, paragraph (39) cross refers to the "age selected by the State pursuant to section 406(a)(2)" (the upper age limit chosen for establishing eligibility as an AFDC child).

Explanation of Provision

This bill clarifies that for purposes of defining the age limit of parents to whom paragraph (39) applies, the age is that selected by the State for purposes of defining a dependent child, without regard to whether the minor parent is attending school. This provision makes clear that only the age limit, and not the school attendance element, was intended to be relevant to the income computation rule of paragraph (39) (thus avoiding any incentive on the part of the minor parent to drop out of school).

This provision makes a conforming change necessitated by the renumbering of the paragraphs of section 457(b) by the Deficit Reduction Act.

6. Child Support Program—Conforming Amendment (sec. 1883(b)(6) of the bill)

Explanation of Provision

7. Federal Incentive Payments in Cases of Interstate Collections (sec. 1883(b)(7) of the bill and sec. 458(d) of the Social Security Act)

Present Law

P.L. 98-378 made a number of amendments to the child support enforcement program. Several of these amendments were designed to encourage States to enforce the more complicated interstate child support obligations which arise when the custodial parent and child(ren) live in one State and the noncustodial parent lives in another State.

Section 458(d) of the Socurity Security Act as established by P.L. 98-378 provides that in interstate cases "support which is collected by one State on behalf of individuals residing in another State shall be treated as having been collected in full by each such State." As a result, in interstate collection efforts, both States are to be credited with the collection for the purposes of calculating the incentive payment.

Explanation of Provision

The bill clarifies the intent of Congress that the incentive be credited to both the State initiating the collection and the State making the collection. It describes the initiating State as the State requesting the collection, rather than the State of residence of the individuals on whose behalf the collection is made. The change is necessary because the State of residence is not always the same as the State initiating the collection request.

8. Exclusion from AFDC Unit of Siblings Receiving Foster Care Maintenance Payments (sec. 1883(b)(9) of the bill)

Present Law

Prior to the addition of the family unit rule in AFDC (section 402(a)(38)) by the Deficit Reduction Act, a sibling of an AFDC child, residing in the AFDC household but receiving foster care maintenance payments under part E of title IV of the Act, was excluded from the AFDC family unit.

Explanation of Provision

The bill adds a new section to part E of title IV to make clear that the sibling (of an AFDC child) receiving foster care maintenance payments is not a member of the AFDC unit. This provision assures that, by authorizing foster care payment in a separate part E, rather than under the predecessor section 408 of the AFDC program, no change will occur in the treatment of the various individuals concerned.

This provision is effective October 1, 1984, the date upon which the AFDC family unit rule (which caused the question to arise) became effective.

C. Technical Corrections to Unemployment Compensation Program

1. Limitation on the Federal Unemployment Tax Act (FUTA) Credit in States Meeting the Solvency Requirements of Section 1202 of the Social Security Act (sec. 1884 of the bill and sec. 3302(f) of the Code)

Present Law

Under present law, States can borrow funds from the Federal Unemployment account if they have insufficient funds in their own unemployment accounts to pay unemployment benefits. Depending on the month in which such a loan is advanced, a State has between 22 and 34 months to repay the loan. If the loan is not repaid in time, the FUTA tax credit for employers in the State is reduced by .3% for each year the loan is in arrears.

The Social Security Act Amendments of 1983 provided for a partial limitation on the FUTA credit reduction in States that take legislative steps to improve the solvency of their unemployment insurance systems. If States meet the solvency test, the FUTA credit reduction is limited to .1% a year for each year a State has a loan in arrears. This limitation on the FUTA credit reduction is in effect for calendar years 1983, 1984 and 1985.

Explanation of Provision

The bill clarifies that the limitation on the FUTA credit reduction in States meeting the solvency test of Section 1202 of the Social Security Act expires at the end of calendar year 1985.

2. Reference to Agricultural Crew Leaders in the Federal Unemployment Tax Act (FUTA) (sec. 1884 of the bill and sec. 3306 of the Code)

Present Law

Section 3306(O)(A)(i) of the Internal Revenue Code provides that for purposes of the Federal Unemployment Tax Act an individual who is a member of a crew furnished by a crew leader to perform agricultural labor for any other person shall be treated as an employee of such crew leader if such crew leader holds a valid certificate of registration under the Farm Labor Contractor Act of 1963. This act has been repealed and replaced with the Migrant and Seasonal Agricultural Workers Protection Act of 1983.

Explanation of Provision

The bill strikes the reference in section 3306 of the Internal Revenue Code of 1954 to the Farm Labor Contractor Act of 1963 and

replaces it with a reference to the Migrant and Seasonal Agricultural Workers Protection Act of 1983.

D. Technical Corrections to the Child Support Enforcement Amendments of 1984

Distribution of Child Support Collections (sec. 1898 of the bill)

Present Law

Section 457(b)(3) of the Social Security Act provides that when child support is collected on behalf of an AFDC child, amounts for current support in excess of the current AFDC payment (for which the State and Federal governments may reimburse themselves), are paid to the family up to the amount of monthly support required by a court order.

Explanation of Provision

The bill changes the reference from the amount required by "court order" to "court or administrative order," to conform it with a parallel provision added to the law by the Child Support Enforcement Amendments of 1984 to use administrative processes for establishing support obligations. This provision is effective on enactment.

E. Technical Corrections to Trade and Tariff Program

1. Amendments to the Tariff Schedules (sec. 1885 of the bill, various provisions of the Tariff Schedules of the United States (TSUS), and Title I of the Trade and Tariff Act of 1984)

a. Telecommunications product classification corrections (sec. 1885(1) of the bill, various provisions of the TSUS, and sec. 124 of the Trade and Tariff Act of 1984)

Present Law

The provisions of part 5 of schedule 6 of the Tariff Schedules applicable to telecommunications products were revised, without changes in rates of duty, under section 124 of the Trade and Tariff Act of 1984, in order to better reflect in the TSUS the state of current technology in such products.

Explanation of Provision

The bill makes conforming changes to several headnotes in the Tariff Schedules which refer to the TSUS items in part 5 of schedule 6 which were changed by section 124 of the Trade and Tariff Act of 1984. It would also add the appropriate column 2 rate of duty for new item 685.34 which was inadvertently omitted from the Act.

This provision is made retroactive to the effective date of the changes in the Telecommunications Act.

b. Miscellaneous corrections (sec. 1885 (2) and (3) of the bill, various provisions of the TSUS, and secs. 111, 112, 123, 146, and 182 of the Trade and Tariff Act of 1984)

The bill makes corrections in the article descriptions of TSUS items 906.38, 907.38, 907.63, 912.13 and in headnote 1 of the part 4D of schedule 1 and headnote 1 of part 4C of schedule 3, as amended by sections 111, 112, 123, 146, 154, and 182 of the Trade and Tariff Act of 1984, in order to correct spelling, utilize proper chemical nomenclature, correct TSUS references and eliminate duplication.

2. Technical Corrections to Countervailing and Antidumping Duty Provisions (sec. 1886 of the bill, Title VII of the Tariff Act of 1930 and sec. 626(b) of the Trade and Tariff Act of 1984)

a. Definition of "interested party" (sec. 1886(a)(2) of the bill and secs. 702(b)(1), and 732(b)(1) of the Tariff Act of 1930)

Present Law

Section 612(a)(3) of the Trade and Tariff Act of 1984 amended section 711(9) of the Tariff Act of 1930 to include industry-labor coali-

tions within the definition of "interested party" for purposes of countervailing duty or antidumping investigations, and section 612(b)(2) made conforming amendments to sections 704(g)(2) and (h)(1) and 734 (g)(2) and (h)(1).

Explanation of Provision

The bill makes similar conforming changes in sections 702(b)(1) and 732(b)(1) of the Tariff Act of 1930 to ensure that industry-labor coalitions will be considered proper petitioners under the countervailing duty and antidumping laws.

b. Imports under suspension agreements (sec. 1886(a)(4) of the bill and sec. 704 of the Tariff Act of 1930)

Present Law

Section 704(b) of the Tariff Act of 1930 authorizes the suspension of countervailing duty investigations if the foreign government or exporters accounting for substantially all imports of the merchandise agree to eliminate or offset the subsidy or to cease exports of the subsidized merchandise within 6 months after the suspension.

Explanation of Provision

The bill restores section 704(d)(2) of the Tariff Act of 1930, which was inadvertently deleted when House provisions deleting the 6-month grace period were not agreed to in House-Senate conference on the Trade and Tariff Act of 1984. Section 704(d)(2) requires that a suspension agreement provide a means of ensuring that exports shall not surge during the 6-month period of phase-in of measures to eliminate or offset subsidies.

The provision also corrects a typographical error in section 704(i)(1)(D) of the Tariff Act of 1930.

c. Waiver of deposit of estimated antidumping duties (sec. 1886(a)(7) of the bill and sec. 7369(c)(1) of the Tariff Act of 1930)

Present Law

Section 736(c)(1) of the Tariff Act of 1930 authorizes the administering authority for 90 days after publication of an antidumping order to continue to permit entry of merchandise subject to the order under bond in lieu of the deposit of estimated duties for individual importers if it has reason to believe these importers have taken steps to eliminate or substantially reduce dumping margins. This provision covers all merchandise entered as of the date of the first affirmative antidumping determination, i.e., whether or not sold to an unrelated purchaser which is necessary to compute price.

Explanation of Provision

The bill amends section 736(c)(1) of the Tariff Act of 1930 to change its scope to cover only entries entered and resold to unrelated purchasers during the period between the first affirmative

antidumping determination and the International Trade Commission's final affirmative determination. This amendment was inadvertently omitted from the Trade and Tariff Act of 1984 as enrolled.

d. Revocation of orders (sec. 1886(a)(8) of the bill, sec. 751(b)(1) of the Tariff Act of 1930, and sec. 611(a)(2)(B)(iii) of the Trade and Tariff Act of 1984)

Present Law

Section 751(b)(1) of the Tariff Act of 1930 as amended by section 611(a)(2)(B)(iii) of the Trade and Tariff Act of 1984 clarifies that the party seeking revocation of an antidumping order has the burden of persuasion as to whether there are changed circumstances sufficient to warrant revocation.

Explanation of Provision

The bill amends section 751(b)(1) of the Tariff Act of 1930 to apply the same standard to revocations of countervailing duty orders as applies to antidumping orders. The amendment corrects an inadvertent omission from the Trade and Tariff Act of 1984 since there is no reason to distinguish between the two types of revocations.

e. Definition of upstream subsidies (sec. 1886(a)(10) of the bill, sec. 771A(a) of the Tariff Act of 1930, and sec. 613 of the Trade and Tariff Act of 1984)

Present Law

Section 771A(a) of the Tariff Act of 1930 as added by section 613 of the Trade and Tariff Act of 1984 defines "upstream subsidies" in part in terms of the types of practices described under section 771(5)(B)(i)(ii), or (iii) of the Tariff Act as domestic subsidies.

Explanation of Provision

The bill amends section 771A(a) of the Tariff Act of 1930 to correct the unintended omission of section 771(5)(B)(iv) from the list of domestic subsidy practices which may constitute an upstream subsidy.

f. Release of confidential information (sec. 1886(a)(13) of the bill, sec. 777 of the Tariff Act of 1930, and sec. 619 of the Trade and Tariff Act of 1984)

Present Law

Section 777 of the Tariff Act of 1930 contains various provisions relating to the release of confidential information. As amended by section 619 of the Trade and Tariff Act of 1984, section 777(b)(1)(B)(i) provides that the administering authority may release such information under an administrative protective order if it is accompanied by a statement of permission.

Explanation of Provision

The bill amends section 777 of the Tariff Act of 1930 to substitute the term "proprietary" for "confidential" throughout the section, a change that was omitted inadvertently from the Trade and Tariff Act of 1984 as enrolled. The provision also amends subsection (b)(1)(B)(i) to correct the inadvertently omission of the International Trade Commission as being permitted to release information, as well as the administering authority, consistent with the rest of the section.

g. Effective dates (sec. 1886(b) of the bill and sec. 626(b) of the Trade and Tariff Act of 1984)

Present Law

Section 626(b) of the Trade and Tariff Act of 1984 made the amendments in sections 602, 609, 611, 612, and 620 of that Act to Title VII of the Tariff Act of 1930 applicable with respect to investigations initiated on or after date of enactment and the amendments made by section 623 were made applicable to civil actions pending or filed on or after date of enactment.

Explanation of Provision

The bill amends paragraph (1) of section 626(b) of the Trade and Tariff Act of 1984 so that the amendments in sections 602, 609, 611, 612, and 620 of the Act will apply to reviews of outstanding antidumping and countervailing duty orders, as well as to new investigations. These orders would involve merchandise entered, or withdrawn from warehouse, for consumption many years after date of enactment. This amendment is consistent with the Congressional intent of these amendments to reduce the cost and increase the efficiency of proceedings.

The bill authorizes the administering authority to delay implementation of any of the amendments to Title VII with respect to investigations in progress on the date of enactment of the Trade and Tariff Act of 1984 if it determines that immediate implementation would prevent compliance with an applicable statutory deadline. New questionnaires would have to be issued to seek information required by certain amendments that may not be obtainable on cases in progress within the statutory deadlines.

The bill also clarifies that the amendment made by section 621 of the Trade and Tariff Act of 1984 to section 778 of the Tariff Act of 1930 concerning the rate of interest payable on overpayments and underpayments of antidumping and countervailing duties is applicable to merchandise unliquidated as of five days after date of enactment, i.e., on or after November 4, 1984, consistent with U.S. Customs Service practice.

h. Miscellaneous corrections (sec. 1886(a) (1), (3), (5), (6), (9), (11), and (12) of the bill)

The bill corrects errors in various provisions of Title VII of the Tariff Act of 1930 concerning subsection designations, cross-references, and printing, grammatical, and typographical errors and provides for the addition of a section heading.

3. Amendments to the Trade Act of 1974 (sec. 1874 of the bill, various sections of the Trade Act of 1974)

a. Miscellaneous corrections (sec. 1887 (1), (2), (3), and (4) of the bill)

The bill makes certain corrections of numbering, subsection designations, cross-references to the United States Code and syntax in amendments to various sections of the Trade Act of 1974 made by the Trade and Tariff Act of 1984.

b. Waiver authority under Generalized System of Preferences (GSP) (sec. 1887(a)(5) and (6) of the bill, secs. 502(b)(4) and 504(c)(3)(D)(ii) of the Trade Act of 1974, and sec. 505 of the Trade and Tariff Act of 1984)

Present Law

Section 504(c)(3)(D)(ii) of the Trade Act of 1974 as added by section 505 of the Trade and Tariff Act of 1974 limits as the President's authority to waive more restrictive GSP competitive need limits with respect to products from advanced beneficiary developing countries to no more than 15 percent of the total value of GSP duty-free imports during the preceding calendar year.

Explanation of Provision

The bill clarifies that the 15-percent limit on the President's waiver authority under section 504(c)(3)(D)(ii) of the Trade Act of 1974 as amended applies to the aggregate value of all waivers granted in a given year with respect to GSP imports from advanced beneficiary countries as a whole, not to each country individually. It also corrects references to the year in which section 504(c)(3)(D)(ii) has its first effect.

c. Transistors (sec. 1887(b) of the bill and sec. 128(b) of the Trade Act of 1974.

The bill corrects an error in numbering of a TSUS line item in section 308 of the Trade and Tariff Act of 1984 which has prevented fully implementing an agreement to reduce U.S. duties on transistors.

4. Amendments to the Tariff Act of 1930 (sec. 1888 of the bill, secs. 304(c) and 313(j) of the Tariff Act of 1930, and secs. 202 and 207 of the Trade and Tariff Act of 1984)

a. Marking of pipes and tubes (sec. 1888 (1) of the bill, sec. 304(c) of the Tariff Act of 1930, and sec. 207 of the Trade and Tariff Act of 1984)

Present Law

Section 207 of the Trade and Tariff Act of 1984 adds a new subsection (c) to section 304 of the Tariff Act of 1930 providing that no exceptions may be made to the marking requirements of section 304 for certain pipes and pipe fittings and requires such products to

be marked with the country of origin by means of die stamping, cast-in-mold lettering, etching, or engraving.

Explanation of Provision

The bill provides a limited exception to the above marking requirement for articles which, due to their nature, may not be marked by one of the four prescribed methods because it is technically or commercially infeasable to do so. Such articles may be marked by an equally permanent method of marking, such as paint stenciling, or in the case of small diameter pipe and tube, by tagging the containers or bundles. Those articles which Customs has determined are capable of being marked by die stamping, cast-in-mold lettering, etching or engraving without adversely affecting their structural integrity or significantly reducing their commercial utility would continue to be marked in this manner.

Further, the tagging of containers or bundles may only be used for small diameter pipes and tubes for which individual marking would be impractical or inconspicuous. In the event that Customs determines that tagging is the only feasible method of marking imported goods so that the ultimate consumer will be appraised of the country of origin of such goods, such products must be bundled and tagged in accordance with applicable industry standards. The Committee directs the U.S. Customs Service to report to the Committee on the operation and effectiveness of this provision within one year after the enactment of this Act.

b. Drawback—incidental operations (sec. 1888)(2) of the bill, sec. 313(j) of the Tariff Act of 1930, and sec. 202 of the Trade and Tariff Act of 1984)

Present Law

Section 202 of the Trade and Tariff Act of 1984 amends section 313(j) of the Tariff Act of 1930 to allow for the substitution of domestic fungible merchandise for imported merchandise under prescribed circumstances and still receive the benefits of drawback when such products are exported. However, incidental operations which may be performed on imported merchandise under section 313(j)(4) without depriving them of drawback privileges may not be performed on such substituted domestic merchandise.

Explanation of Provision

The bill redesignates paragraphs (3) and (4) of section 313 as (2) and (3), respectively, and amends paragraph (3) as redesignated so that incidental operations may be performed on both domestic and imported merchandise so that the intent of the original provision (i.e., allowing fungible domestic and imported merchandise to be mixed together and still be entitled to drawback) is accomplished.

c. Interested parties (sec. 1888 (4) and (5) of the bill and secs. 514(a) and 516(a)(2) of the Tariff Act of 1930)

Present Law

Section 771(9) of the Tariff Act of 1930, as amended by section 612(a) of the Trade and Tariff Act of 1984, defines the term "interested party" for purposes of countervailing duty or antidumping proceedings to include industry-labor coalitions. The term is also used in the provisions for judicial review of such proceedings under Title V of the Tariff Act of 1930.

Explanation of Provision

The bill amend sections 514(a) and 516(a)(2) of the Tariff Act of 1930 to conform the definition of the term "interested party" to the inclusion of industry-labor coalitions under section 771(9) of the Tariff Act of 1930.

d. Miscellaneous corrections (sec. 1888(3) and (6) of the bill and secs. 339(c)(2)(A) and 516A(a)(3) of the Tariff Act of 1930)

Section 1594(3) of the bill corrects a cross-reference to a title in section 339(c)(2)(A) of the Tariff Act of 1930, as added by section 221 of the Trade and Tariff Act of 1984. Section 1594(6) of the bill corrects an erroneous paragraph reference in section 516A(a)(3) of the Tariff Act as amended by section 623(a)(4) of the Trade and Tariff Act of 1984.

e. Customs Provision (sec. 1888(7) of the bill and sec. 613(a) of the Tariff Act of 1930

The bill deletes the Customs Forfeiture Fund created by the 1985 Continuing Resolution, which duplicated the existing Customs Forfeiture Fund .

5. Amendments to the Trade and Tariff Act of 1984 (sec. 1889 of the bill, secs. 126, 174(b), 212, 234(a), 304(d)(2)(A), 307(b)(3), and 504 of the Trade and Tariff Act of 1984)

a. Chipper knife steel (sec. 1889(1) of the bill and sec. 126 of the Trade and Tariff Act of 1984)

The bill deletes unnecessary language inserted by the Trade and Tariff Act of 1984.

b. Watch glasses (sec. 1889(2) of the bill and sec. 174(b) of the Trade and Tariff Act of 1984)

Present Law

Section 174 of the Trade and Tariff Act of 1984 reduced the level of duty on watch glasses other than round to the same level as the duty applicable to round watch glasses. However, the Act does not provide for the third-year staged reduction on January 1, 1987, for watch glasses other than round.

Explanation of Provision

The bill amends section 174(b) of the Trade and Tariff Act of 1984 to provide for the third-year reduction to 4.9 percent ad valorem for such watch glasses.

c. Miscellaneous corrections (sec. 1889 (3), (4), (5), (6), and (7) of the bill)

The bill corrects paragraph designations and number and statutory references in various sections of the Trade and Tariff Act of 1984.

6. Amendments to the Caribbean Basin Economic Recovery Act (sec. 1890 of the bill, sec. 213 of the Caribbean Basin Economic Recovery Act, and sec. 235 of the Trade and Tariff Act of 1984)

Present Law

Section 235 of the Trade and Tariff Act of 1984 amended section 213(a) of the Caribbean Basin Economic Recovery Act (CBI) to allow products of a beneficiary country to be processed in a bonded warehouse in Puerto Rico after being imported directly from such country and be eligible for duty-free treatment under the CBI upon withdrawal from warehouse if they meet the rule-of-origin requirements set out in paragraph (1)(B) of section 213(a).

Explanation of Provision

The bill corrects a reference to a wrong Tariff Schedules item in section 213(f)(5)(B) of the Caribbean Basin Economic Recovery Act and clarifies that products entering Puerto Rico directly from any CBI beneficiary country, not merely the country of manufacture, should quality for entry under bond.

7. Conforming Amendments Regarding Customs Brokers (sec. 1891 of the bill, Title 28 of the United States Code, and sec. 212(b) of the Trade and Tariff Act of 1984)

The bill makes corrections to conforming amendments made by section 212(b) of the Trade and Tariff Act of 1984 in Title 28 of the U.S. Code to cross-references in the Tariff Act of 1930 relating to customs brokers and deletes an incorrect reference in section 1581(g)(1) of Title 28.

8. Special Effective Date Provisions for Certain Articles Given Duty-Free Treatment Under the Trade and Tariff Act of 1984 (sec. 1891 of the bill and secs. 112, 115, 118, 167, and 179 of the Trade and Tariff Act of 1984)

Present Law

Sections 112, 115, 118, 167, and 179 of the Trade and Tariff Act of 1984 were made effective 15 days after enactment because the provisions providing for retroactive application of such provisions were inadvertently omitted from the Act.

Explanation of Provision

The bill provides for the retroactive application of sections 112, 115, 118, 167, and 179 of the Trade and Tariff Act of 1984.

TECHNICAL CORRECTIONS RELATED TO THE RETIREMENT EQUITY ACT OF 1984

A. Minimum Participation, Vesting, and Benefit Accrual Standards (sec. 1897(a) of the bill, sec. 203(c) of ERISA, and secs. 402 and 411 of the Code)[16]

If a pension, profit-sharing, or stock bonus plan qualifies under the tax law (Code sec. 401(a)), then the plan is accorded special tax treatment. With respect to such a qualified plan, (1) a trust under the plan generally is exempt from Federal income tax, (2) employers are generally allowed deductions (within limits) for plan contributions for the year for which the contributions are made, even though participants are not taxed on plan benefits until the benefits are distributed, (3) benefits distributed as a lump-sum distribution may be accorded special long-term capital gain or 10-year income averaging treatment, and (4) certain plan distributions may be rolled over, tax-free, to an individual retirement arrangement (IRA) or to another qualified plan.

Under a pension plan (including a profit-sharing or stock bonus plan), benefits are provided to plan participants under formulas that determine the benefit a participant may earn, the portion of that benefit that has been earned, and the portion of the earned benefit that is nonforfeitable. Accordingly, such plans provide rules for determining whether an employee is a plan participant (the participation rules), for determining the portion of the benefit that has been earned (the benefit accrual rules), and for determining the nonforfeitable percentage of a participant's accrued benefit (the vesting schedule).

Under present law, a pension plan plan must satisfy certain minimum standards relating to (1) the conditions under which employees may be excluded from plan participation, (2) the rate at which plan benefits are accrued, and (3) the rate at which benefits become nonforfeitable. The participation standards limit exclusions based on the age and number of years of service completed by an employee.[17] The benefit accrual standards are based on the number of years of plan participation. The vesting standard generally is based on the number of years of service with the employer completed by the employee.

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[16] References to ERISA mean the Employee Retirement Income Security Act of 1974, and references to the Code mean the Internal Revenue Code of 1954.

[17] In addition, the Code provides participation rules for qualified plans. These rules are designed to require that qualified plans provide participation to a broad cross-section of employees.

1. Break-in-service rules

Present Law

In general

All years of service with the employer maintaining a pension plan are taken into account for purposes of determining (1) an employee's eligibility to participate in the plan, and (2) the portion of a participant's accrued benefit that is vested. No credit need be provided, however, for periods during which an employee is considered to have a break in service. In some cases, an employee who returns to work for an employer after a break in service may lose credit for service earned prior to the break in service.

Under REA, in the case of a nonvested participant, years of service completed with the employer or employers maintaining the plan before any period of consecutive one-year breaks in service are required to be taken into account after a break in service, unless the number of consecutive one-year breaks in service equals or exceeds the greater of (1) five years, or (2) the aggregate number of years of service before the consecutive one-year breaks in service.

In addition, in the case of a participant in a defined contribution plan or in a defined benefit pension plan funded solely by certain insurance contracts, years of service after a break in service are not counted for purposes of determining the vested percentage of the participant's accrued benefit derived from employer contributions before the break in service, if the participant incurs at least five consecutive one-year breaks in service.

Class-year vesting

In a class-year plan, employees' rights to benefits attributable to contributions made on their behalf with respect to any plan year are required to be nonforfeitable not later than the close of the fifth plan year following the plan year for which the contributions were made. A class-year plan is a profit-sharing, stock bonus, or money purchase pension plan that provides for the separate vesting of employee's rights to employer contributions with respect to each plan year.

Under REA, the application of the expanded break-in-service rules to class-year plans was not explicitly stated.

Lump-sum distributions

REA did not explicitly conform the expanded break-in-service rules with the rules relating to the taxation of lump-sum distributions. If an employee separates from service and receives a distribution prior to the time at which the employee incurs five consecutive one-year breaks in service, the potential increase in vesting that might occur if the employee returned to service may make the distribution ineligible for special 10-year income averaging tax treatment (Code sec. 402(e)).[18]

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[18] See generally, Temp. Treas. Reg. sec. 11.401(e)(4)(A)-1(a).

Rollovers

A similar problem may occur if an employee separates from service and rolls over to an IRA or to another qualified plan any portion of a lump-sum distribution representing 100 percent of the employee's partially vested accrued benefit. If the employee returns to service with the employer before incurring five consecutive one-year breaks in service, then the employee's prior rollover contribution may be treated as failing to meet the rollover requirements (Code sec. 402(a)(5)).

Elapsed time method of crediting service

Under present law,[19] an alternative method of crediting service is provided under which an employer's rights with respect to plan participation, vesting, and benefit accrual are not based on the actual completion of a specified number of hours of service. This elapsed time method of crediting service is designed to lessen the administrative burdens of recordkeeping.

Treasury regulations[20] have provided some guidance relating to the application of the maternity and paternity leave provisions of REA to plans using the elapsed time method, but the regulations did not address the application of the break in service rules of REA to plans using the elapsed time method.

Explanation of Provision

Class-year vesting

The bill generally conforms the break-in-service rules applicable to class-year plans to the break-in-service rules provided for other types of plans. Under the bill, a class-year plan generally is to provide that 100 percent of each participating employee's right to benefits derived from employer contributions for a plan year (the contribution year) is to be nonforfeitable as of the close of the fifth plan year of service (whether or not consecutive) with the employer following the contribution year. A plan year is a plan year of service with the employer if the participant has not separated from service with the employer as of the close of the year.

The bill provides that, if a participant incurs five consecutive one-year breaks in service before the completion of five plan years of service with respect to a contribution year, then the plan may provide that the participant forfeits any right to or derived from the employer contributions for the contribution year.

The provision is effective for contributions made for plan years beginning after the date of enactment, except that the provision is not effective with respect to a collectively bargained plan until the applicable effective date of the Act for that plan.

Lump-sum distributions

The bill conforms the rules relating to the taxation of lump-sum distributions to the break-in-service rules. Under the bill, in determining whether any distribution payable on account of separation

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[19] Treas. Reg. sec. 1.410(a)-7.6601

[20] Temp. Treas. Reg. sec. 1.410(a)-7T.

from service is a lump sum distribution, the balance to the credit of the employee is determined without taking into account any increase in vesting that could occur if the employee is reemployed by the employer.

Under the bill, however, if the employee is reemployed by the employer before the occurrence of five consecutive one-year breaks in service and the nonforfeitable interest of the employee in the amount of the pre-break accrued benefit is thereby increased, then the reduction in tax attributable to the treatment of the distribution as a lump-sum distribution is to be recaptured as provided by Treasury regulations. Such a reduction in tax could occur on account of an election to use 10-year forward averaging with respect to a lump-sum distribution, the special treatment of net unrealized appreciation of employer securities (Code sec. 402(e)(4)(J)), or long-term capital gains treatment for a portion of a lump-sum distribution. In addition, if such a recapture is made, the participant's previous lump sum distribution election is not taken into account in determining whether the employee is eligible to make another election.

Rollovers

The bill provides that, in determining whether a distribution to an employee on account of separation from service is eligible to be rolled over to another plan or to an IRA, the balance to the credit of the employee is determined without regard to any increased vesting that may occur if the employee returns to service with the employer. However, if (1) the employee excluded the distribution from income on account of a rollover, (2) the employee returns to service with the employer before incurring five consecutive one-year breaks in service and (3) the vested percentage of benefits accrued before the separation from service is increased, then any subsequent distributions to the employee from the plan in which the increased vesting occurs are not eligible for 10-year income averaging or capital gains treatment.

The rule denying eligibility for 10-year forward averaging or capital gains treatment on subsequent distributions does not apply if the distribution that was rolled over was made without the consent of the participant (e.g., the amount distributed did not exceed $3,500).

Elapsed time method of crediting service

The committee directs the Treasury Department to provide, within a reasonable period of time after the date of enactment, additional guidance to taxpayers on the application of the break in service rules to plans that use the elapsed time method of crediting service. It is not intended that such guidance is to be limited to the issuance of regulations.

2. Mandatory employee contributions

Present Law

Under present law, a right to an accrued benefit derived from employer contributions under a pension plan is not treated as forfeitable merely because the plan provides that, in the case of a par-

ticipant who is not at least 50 percent vested in the accrued benefits derived from employer contributions, the accrued benefit may be forfeited if the employee withdraws any portion of the mandatory contributions. Mandatory employee contributions mean amounts contributed to the plan by the employee that are required (1) as a condition of employment, (2) as a condition of participation in the plan, or (3) as a condition of obtaining benefits under the plan attributable to employer contributions.

The rule permitting the forfeiture of certain employer contributions does not apply unless the plan provides that any accrued benefit forfeited is restored upon repayment by the participant of the amount of mandatory contributions withdrawn. In the case of a defined contribution plan, the plan may provide that such repayment must be made before the participant has a single one-year break in service after the withdrawal.

A similar rule permits certain service to be disregarded if attributable to amounts distributed to the employee on account of a separation from service. This rule applies for purposes of determining the period of an employee's service in calculating accrued benefits under a plan, but does not permit prior service to be disregarded until the employee has at least five consecutive one-year breaks in service.

Explanation of Provision

The bill conforms the rule relating to the period for repayment of mandatory contributions to the rule relating to the repayment of accrued benefits after separation from service and extends both rules to apply in the case of a defined benefit plan as well as a defined contribution plan. The provision clarifies that the repayment period during which a plan must permit an employee to repay mandatory contributions does not end before a participant has five consecutive one-year breaks in service.

A plan may provide that repayment of withdrawn amounts is required to be made no later than (1) five years after the date of the withdrawal or (2) in the case of a distribution on account of separation from service, the earlier of (a) five years after the date the individual is reemployed by the employer or (b) the date upon which the individual incurs five consecutive one-year breaks in service.

3. Maximum age requirement

Present Law

The Act reduced from 25 to 21 the maximum age requirement that a pension plan may impose as a condition of plan participation. Thus, under the Act, a pension plan generally may not require, as a condition of participation, completion of more than one year of service or attainment of an age greater than 21 (whichever occurs later). The Act did not lower the maximum age requirement applicable to simplified employee pensions (SEPs).

Explanation of Provision

The bill reduces from 25 to 21 the maximum age requirement that a SEP may impose as a condition of plan participation. Thus,

a SEP may not require, as a condition of participation, attainment of an age greater than 21 or the performance of service during more than three of the immediately preceding five calendar years (whichever occurs later).

B. Survivor Benefit Requirements (sec. 1897(b) of the bill, sec. 205 of ERISA, and secs. 401 and 417 of the Code)

1. Coordination between qualified joint and survivor annuity and qualified preretirement survivor annuity

Present Law

A pension plan (including certain profit-sharing or stock bonus plans) is generally required to provide survivor benefits to the spouse of a plan participant who survives the participant. In the case of a participant who retires under the plan, the participant's accrued benefit is to be paid in the form of a qualified joint and survivor annuity, unless the participant and the participant's spouse (if any) waive the joint and survivor annuity in favor of another form of benefit.

Present law requires that, in the case of a vested participant who dies before the participant's annuity starting date, the participant's surviving spouse is to receive a qualified preretirement survivor annuity unless the benefit was previously waived by the participant with the spouse's consent. The participant's annuity starting date is defined as the first day of the first period for which an amount is received as an annuity, whether by reason of retirement or disability, under the plan.

It is unclear under present law which of the survivor benefit provisions (i.e., the qualified joint and survivor annuity provisions or the qualified preretirement survivor annuity provisions) apply in the case of (a) a participant who retires, or attains the normal retirement age under the plan, but dies prior to the participant's annuity starting date, and (2) a participant who receives a disability benefit under a plan.

Explanation of Provision

In general

The bill clarifies and coordinates the application of the qualified joint and survivor annuity and qualified preretirement survivor annuity provisions in the case of (1) an individual who dies before or after the annuity starting date, and (2) an individual who receives a disability benefit under a plan.

Coordination of preretirement survivor annuity and joint and survivor annuity

The bill provides that the survivor benefit payable to a participant's spouse is to be provided in the form of a qualified joint and survivor annuity if the participant does not die before the annuity starting date unless the benefit is waived in favor of another benefit and the spouse consents to the waiver. As under present law, the qualified preretirement survivor annuity rules apply in the

case of a death before the annuity starting date if the preretirement survivor annuity has not been waived.

Thus, if a participant dies after separation from service or attainment of normal retirement age, but prior to the participant's annuity starting date, the survivor benefit payable to the participant's spouse is to be paid in the form of a qualified preretirement survivor benefit.

Disability benefits

The bill amends the definition of a participant's annuity starting date to exclude the commencement of disability benefits, but only if the disability benefit is an auxiliary benefit. If a participant receiving a disability benefit will, upon attainment of early or normal retirement age, receive a benefit that satisfies the accrual and vesting rules of section 411 (without taking the disability benefit payments up to that date into account), the disability benefit may be characterized as auxiliary.

For example, consider a married participant who becomes disabled at age 45 with a deferred vested accrued benefit of $100 per month commencing at age 65 in the form of a joint and survivor annuity. If the participant is entitled under the plan to a disability benefit and is also entitled to a benefit of not less than $100 per month commencing at age 65, whether or not the participant is still disabled, the payments made to the participant between ages 45 and 65 would be considered auxiliary. Thus, the participant's annuity starting date would not occur until the participant attained age 65. The participant's surviving spouse would be entitled to receive a qualified preretirement survivor annuity if the participant died before age 65, and the survivor portion of a qualified joint and survivor annuity if the participant died after age 65. The value of the qualified preretirement survivor annuity payable upon the participant's death prior to age 65 would be computed by reference to the qualified joint and survivor annuity that would have been payable had the participant survived to age 65.

If, in the above example, the participant's benefit payable at age 65 were reduced to $90 per month as a result of the disability benefits paid to the participant prior to age 65, the disability benefit would not be auxiliary. The benefit of $90 per month payable at age 65 would not, without taking into account the disability benefit payments prior to age 65, satisfy the minimum vesting and accrual rules of section 411 of the Code. Accordingly, the first day of the first period for which the disability payments were made would constitute the participant's annuity starting date, and any benefits paid to the participant would be required to be paid in the form of a qualified joint and survivor annuity (unless waived by the participant with the consent of the spouse).

2. Transferee plan rules

Present Law

The provisions requiring survivor benefits generally apply to any pension plan. However, the survivor benefit requirements do not apply with respect to a participant under a profit-sharing or stock bonus plan if (1) the plan provides that the nonforfeitable accrued

benefits of a deceased participant will be paid to the surviving spouse of the participant (or to another beneficiary if the surviving spouse consents or if there is no surviving spouse), (2) under a plan that provides for benefits in the form of a life annuity, the participant does not elect payment of benefits in the form of a life annuity, and (3) with respect to the participant, the plan is not a direct or indirect transferee of a plan required to provide survivor benefits.

A plan is a transferee of a plan required to provide survivor benefits if the plan (1) receives a direct transfer of assets in connection with a merger, spinoff, or conversion of a plan that is subject to the survivor benefit requirements, or (2) receives a direct transfer of assets solely with respect to the participant. Also, a plan is a transferee plan with respect to a participant if it receives amounts from a plan that is a transferee plan with respect to that participant. A plan is not a transferee plan merely because it receives rollover contributions from another plan. The transferee plan rules do not apply in the case of a rollover contribution because the consent of the participant's spouse had to be obtained in order to make the plan distribution that qualified for rollover treatment.

Explanation of Provision

The bill includes two provisions relating to the transferee plan rules. First, the bill clarifies that a plan is not to be considered a transferee plan on account of a transfer completed before January 1, 1985.

In addition, the bill clarifies that the transferee plan rule is limited to benefits attributable to the transferred assets if separate accounting is provided for the transferred assets and the allocable investment yield from those assets. Under the bill, if separate accounting is not maintained for transferred assets (and any allocable investment yield) with respect to an employee, then the survivor benefit requirements apply to all benefits payable with respect to the employee under the plan.

3. Rules relating to qualified preretirement survivor annuity

Present Law

A qualified preretirement survivor annuity is defined as an annuity for the life of the surviving spouse of the participant. The amount of each payment under a qualified preretirement survivor annuity is not to be less than the payment that would have been made under a qualified joint and survivor annuity if (1) in the case of a participant who dies after attaining the earliest retirement age under the plan, the participant had retired with an immediate qualified joint and survivor annuity on the day before the participant's death, and (2) in the case of a participant who dies on or before the earliest retirement age under the plan, the participant had separated from service on the date of death, survived until the earliest retirement age, and retired at that time with a qualified joint and survivor annuity. Under present law, the term "earliest retirement age" is defined as the earliest date on which, under the plan, the participant could elect to receive retirement benefits.

Under a special rule for defined contribution plans that are subject to the survivor benefit requirements, the term "qualified preretirement survivor annuity" is defined as an annuity for the life of the surviving spouse the actuarial equivalent of which is not less than 50 percent of the account balance of the participant as of the date of death.

A plan may permit a surviving spouse to elect to have survivor benefits paid in a form other than an annuity, but only if the value of the alternative form of benefits is not less than the actuarial equivalent of the required survivor benefit.

For purposes of the survivor benefit requirements, a vested participant is any participant (whether or not still employed by the employer at the time of death) who has a nonforfeitable right to any portion of the accrued benefit under the plan derived from employer contributions.

A plan that is subject to the survivor benefit requirements may nevertheless provide that a joint and survivor annuity or a qualified preretirement survivor annuity will not be paid unless the participant and spouse have been married throughout the one-year period ending on the earlier of the participant's annuity starting date, or the date of the participant's death. However, in the case of a plan that is exempt from the survivor benefit requirements, because the plan provides that the nonforfeitable accrued benefits of a deceased participant will be paid to the surviving spouse of the participant, present law is unclear as to whether the plan may provide for the payment of the participant's nonforfeitable accrued benefit (without the consent of the surviving spouse) to a beneficiary other than the surviving spouse, unless the participant and surviving spouse have been married at least one year as of the death of the participant.

Explanation of Provision

The bill clarifies that, in the case of a participant who separates from service prior to death, the amount of the qualified preretirement survivor annuity is to be calculated by reference to the actual date of separation from service, rather than the date of death. Thus, for purposes of calculating the qualified preretirement survivor annuity, a participant is not to be considered to accrue benefits after the date of separation from service.

The bill also clarifies that, under the special rule for defined contribution plans, a qualified preretirement survivor annuity payable to a participant's surviving spouse is required to be the actuarial equivalent of not less than 50 percent of the account balance in which the participant was vested as of the date of death. For purposes of determining who is a vested participant subject to the survivor benefit provisions, the bill provides that a participant's accrued benefit includes accrued benefits derived from employee contributions.

The bill also clarifies that a plan that is exempt from the survivor benefit may provide for the payment of the participant's nonforfeitable accrued benefit (without the consent of the participant's surviving spouse) to a beneficiary other than the participant's

spouse if the participant and spouse have been married for less than 1 year as of the death of the participant.

The committee intends that, with respect to a defined benefit or defined contribution plan, the qualified preretirement survivor annuity is to be treated as attributable to employee contributions in the same proportion which the employee contributions are to the total accrued benefit of the participant. Thus, a plan is not permitted to allocate a preretirement survivor annuity only to employee contributions.

The committee is aware that questions have arisen concerning the definition of a participant's "earliest retirement age." The committee intends that a participant's "earliest retirement age" should be determined by taking in account only the participant's actual years of service at the time of the participant's separation from service or death. Thus, in the case of a plan under which participants may not receive a benefit under the plan until the participant attains age 65, or upon attainment of age 55 and completion of 10 years of service, the earliest retirement age of a participant who died or separated from service with only 8 years of service would be age 65. On the other hand, if a participant died or separated from service after completing 10 years of service, the earliest retirement age would occur when the participant would have attained age 55 (if the participant had survived).

4. Spousal consent requirements

Present Law

Under present law, the consent of a participant's spouse is required for an election to waive the qualified joint and survivor annuity or the qualified preretirement survivor annuity. This consent is to be given in writing at the time of the participant's election, and the consent is to acknowledge the effect of the election. A consent is not valid unless it is witnessed by a plan representative or a notary public. Any consent obtained is effective only with respect to the spouse who signs it. Spousal consent to a waiver is not required if it is established to the satisfaction of a plan representative that there is no spouse because the spouse cannot be located, or because of such other circumstances as the Secretary of the Treasury may by regulations prescribe.

A spouse's consent to waive a death benefit under a profit-sharing or stock bonus plan not otherwise subject to the survivor benefit requirements is to be made in the same manner as the spousal consent to waive a qualified joint and survivor annuity or a qualified preretirement survivor annuity. REA does not require spousal consent under an exempt profit-sharing or stock bonus plan to be made at the same time as spousal consent under a plan subject to the survivor benefit requirements. Thus, REA generally does not require that spousal consent be obtained to make a distribution, such as an in-service withdrawal, to a participant under a profit-sharing or stock bonus plan not subject to section 401(a)(11).

A plan may immediately distribute the present value of the benefit under either the qualified joint and survivor annuity or the qualified preretirement survivor annuity if the present value of the benefit does not exceed $3,500. An accrued benefit is immediately

distributable if any part of the benefit may be distributed to the participant before the later of the normal retirement age or age 62.

No "cash-out" may be made after the annuity starting date unless the participant and the participant's spouse (or the surviving spouse of the participant) consent in writing to the distribution. Thus, a plan could permit a participant and the participant's spouse (or a participant's spouse) to change the form of benefits received under the plan after the annuity starting date.

In addition, if the present value of the benefit under the qualified joint and survivor annuity or the qualified preretirement survivor annuity exceeds $3,500, then the consent of the participant and spouse (or the surviving spouse if the participant has died) must be obtained before the plan can immediately distribute any part of the present value in a form other than a qualified joint and survivor annuity or a qualified preretirement survivor annuity.

Present law does not preclude a plan from permitting a spouse to make a conditional waiver of a survivor benefit. For example, a plan could offer a spouse the right to waive a qualified preretirement survivor annuity, effective only if the present value of the annuity is less than another death benefit payable to the spouse under the plan.

Under present law it is unclear whether the waiver of a qualified joint and survivor annuity or a qualified preretirement survivor annuity by a nonparticipant spouse is a taxable transfer for purposes of the gift tax provisions.

Explanation of Provision

Designation of nonspouse beneficiary

Under the bill, a spouse's consent to waive a qualified joint and survivor annuity or a qualified preretirement survivor annuity is not valid unless the consent (1) names a designated beneficiary who will receive any survivor benefits under the plan and the form of any benefits paid under the plan (including the form of benefits that the designated beneficiary will receive), or (2) acknowledges that the spouse has the right to limit consent only to a specific beneficiary or a specific form of benefits, and that the spouse voluntarily elects to relinquish one or both of such rights.

The spousal consent form is to contain such information as may be appropriate to disclose to the spouse the rights that are relinquished. If the consent names a designated beneficiary, then any subsequent change to the beneficiary designation (or the form of distribution, if any, specified in the consent) is invalid unless a new consent is obtained from the participant's spouse. Of course, spousal consent is not required if a participant dies and the beneficiary designated (with spousal consent) to receive the participant's death benefit elects to receive the benefit in a form not specified in the waiver.

If a plan is required to permit the waiver of a survivor benefit, the committee intends that the plan may not restrict the spouse's ability to waive a benefit by providing only a general consent to waive under which a spouse relinquishes the right to designate a beneficiary or a form of benefit. Thus, a spouse is always permitted to waive a survivor benefit only in favor of a specific beneficiary or

a specific form of benefit. The committee intends that, if a plan permits a general consent, the acknowledgment of the general consent should indicate that the spouse is aware that a more limited consent could be provided.

Similar rules relating to the manner in which spousal consent is obtained apply to a spousal consent obtained to waive a death benefit under a profit-sharing or stock bonus plan that is not otherwise subject to the survivor benefit requirements.

Spousal consent with respect to loans

In addition, under the bill, in the case of a participant's benefit that is not exempt from the survivor benefit requirements, a plan is to provide that no portion of the accrued benefit of the participant may be used as security for any loan unless, at the time the security agreement is entered into, the participant's spouse (determined as of the date the security agreement is entered into) consents to the use of the accrued benefit as security. If the individual who is the participant's spouse at the time that the security agreement is entered into consents, then the plan is not prevented by the spousal consent rules from realizing its security interest in the event of a default on the participant's loan, even if, at the time of the default, the participant is married to a different spouse. Similarly, if a participant is not married at time the security agreement is executed, then the plan is not prevented from realizing its security interest if a default on the loan subsequently occurs when the participant is married.

For example, assume that a spouse consents to a pledge of the participant's account balance as security for a loan from the plan. Under the plan, the plan administrator is to realize on the security for the loan if it is not repaid by the time the employee separates from service. Because the spouse consented to the loan, the plan is not prevented from using the security (i.e., the account balance) to recover the amount due on the loan. In addition, if the participant had remarried after the loan was made but before the plan realized on its security, then the consent of the first spouse would continue to be effective for purposes of determining the plan's ability to realize its security interest.

In the case of a participant whose accrued benefit is not subject to the survivor benefit provisions at the time the security is provided (e.g., a profit-sharing plan that is not a transferee plan with respect to the participant), the plan will not be treated as failing to meet the survivor benefit requirements if the participant's benefit is used as security for a loan and spousal consent is not obtained for the use of the accrued benefit as security, even if the plan subsequently becomes subject to the survivor benefit requirements with respect to the participant.

The bill further clarifies that for purposes of determining the survivor benefit, if any, to which a participant's surviving spouse is entitled upon the participant's death, any security interest held by the plan by reason of a loan outstanding to the participant is taken into account and, if there is a default on the loan, then the participant's nonforfeitable accrued benefit is first reduced by any security interest held by the plan by reason of a loan outstanding to the participant. The rule applies only if (a) the loan is secured by the

participant's accrued benefit and (b) the spousal consent requirements, if any, applicable to the participant's accrued benefit at the time the security arrangement was entered into were satisfied. In addition, the participant's nonforfeitable accrued benefit is adjusted (where appropriate), taking into account the terms of the plan and the terms of the qualified domestic relations order, by the value of amounts payable under any outstanding qualified domestic relations order, for purposes of determining the survivor benefit, if any, to which the participant's surviving spouse is entitled upon the participant's death.

Similarly, upon a married participant's retirement, for purposes of determining the amount of the joint and survivor annuity payable to the participant and spouse, any security held by the plan by reason of a loan outstanding to the participant and the present value of any outstanding qualified domestic relations order are taken into account in the same manner as they are taken into account for purposes of the qualified preretirement survivor annuity.

Determination of amount of preretirement survivor annuity

The bill provides that, in the case of a defined contribution plan subject to the survivor benefit requirements, the participant's vested account balance (including any portion of the account balance attributable to employee contributions) is used for purposes of determining the amount of the qualified preretirement survivor annuity.

Scope of spousal consent requirements

The bill clarifies that certain of the election period and notice requirements with respect to spousal consent also apply in the case of spousal consent (1) to waive a survivor benefit under a plan exempt from the preretirement survivor annuity and joint and survivor annuity requirements, (2) to permit the participant's accrued benefit to be pledged as security for a loan, (3) to permit the election of a cash-out of amounts after the annuity starting date, and (4) to permit the immediate distribution of amounts in excess of $3,500.

In the case of a loan secured by a participant's accrued benefits, the notice and election period requirements apply at the time the security arrangement is entered into. Consequently, the election period for spousal consent with respect to the execution of a security agreement is the 90-day period before the execution of the agreement.

Similarly, in the case of a cash out subsequent to a participant's annuity starting date, the election period is the 90-day period before the distribution is permitted.

The committee intends that, for purposes of the spousal consent rules, in the case of a participant residing outside of the United States, that spousal consent may be witnessed by the equivalent of a notary public in the jurisdiction in which consent is executed. The committee also intends that an election under section 242(b) of the Tax Equity and Fiscal Responsibility Act of 1982 will not be invalidated because a plan secures spousal consent to the election.

In addition, the committee intends that a participant will be treated as having no spouse, if the participant has been abandoned

(within the meaning of local law) by the spouse, even if the participant knows where the spouse is located. The committee intends that the spousal consent requirement may be waived, however, only if the participant has a court order specifying that the participant has been abandoned within the meaning of local law. Of course, a participant could provide a qualified domestic relations (such as a separation agreement) rather than a court order specifying that the participant has been abandoned.

Gift tax consequences of waiver

The bill provides that the waiver of a qualified joint and survivor annuity or a qualified preretirement survivor annuity by a nonparticipant spouse prior to the death of the participant does not result in a taxable transfer for purposes of the gift tax provisions.

Effective Dates

The provision relating to spousal consents to beneficiary designations is effective for consents given on or after January 1, 1985. The provision relating to the notice and election period requirements for plans that are exempt from the survivor benefit requirements is effective upon the date of enactment.

The provision relating to accrued benefits pledged as security for a loan is effective for loans made after August 18, 1985. In addition, any accrued benefits pledged as security for a loan prior to August 19, 1985, are exempt from the requirement that spousal consent be obtained. Accordingly, in the case of a pledge made before August 19, 1985, a plan is not required to obtain the consent of any spouse of a participant before it applies the benefit against the loan. Finally, any loan that is revised, extended, renewed, or renegotiated after August 18, 1985, is treated as a loan made (and security pledged) after August 18, 1985.

5. Notice requirement

Present Law

A plan is required to notify participants of their rights to decline a qualified preretirement survivor annuity before the applicable election period. This notice is to be provided within the period beginning on the first day of the plan year in which the participant attains age 32 and ending with the close of the plan year in which the participant attains age 35. This notice is to be comparable to the notice required with respect to the qualified joint and survivor annuity. The qualified preretirement survivor benefit coverage may become automatic prior to the time that the participant is entitled to decline such coverage.

Explanation of Provision

The bill provides that the period during which notice is required to be provided to an individual does not end before the latest of (1) the close of the plan year in which a participant attains age 35; (2) a reasonable period of time after the individual becomes a plan participant; (3) a reasonable period of time after the survivor benefit applicable to a participant is no longer subsidized (as defined in

Code sec. 417(a)(4)); or (4) a reasonable period of time after the survivor benefit provisions (Code sec. 401(a)(11)) become applicable with respect to a participant.

The bill also provides that if a participant separates from service prior to age 35, the plan must provide the participant with notice, within a reasonable time after separation from service, of the right to decline a qualified preretirement survivor annuity.

6. Clarification of rule for subsidized benefits

Present Law

Under REA, a plan is not required to provide notice of the right to waive the qualified joint and survivor annuity or the qualified preretirement survivor annuity if the plan fully subsidizes the cost of the benefit. A plan fully subsidizes the cost of a benefit only if the failure to waive the benefit by a plan participant does not result in either (1) a decrease in any plan benefits with respect to the participant, or (2) in increased plan contributions by the participant.

Explanation of Provision

The bill clarifies that a plan is not required to provide a participant with a right to waive a qualified joint and survivor annuity or qualified preretirement survivor annuity if the plan fully subsidizes the cost of the benefit.

The bill further clarifies that the present-law exception to the notice requirement only applies if (1) the plan fully subsidizes the benefit, and (2) the plan does not permit a participant to waive the benefit or to designate as another beneficiary.

The committee intends that a benefit is not to be considered fully subsidized if the cost of the survivor benefit is spread among all plan participants, including participants who are not married, or among some subgroup of participants, even if the benefits and contributions of those charged with the cost of survivor benefit protection are unaffected by the waiver or failure to waive survivor benefit protection. Of course, if a participant is not entitled to waive a survivor benefit, the participant cannot be charged for the benefit.

7. Clarification of annuity starting date

Present Law

Present law provides that the annuity starting date means the first period for which an amount is received as an annuity (whether by reason of death or disability).

Explanation of Provision

Under the bill, the definition of the annuity starting date is amended to provide that, in the case of a benefit not payable in the form of an annuity, the annuity starting date is the date on which such benefit is actually paid or begins to be paid.

C. Qualified Domestic Relations Orders (sec. 1897(c) of the bill, sec. 206 of ERISA, and secs. 502 and 414(p) of the Code)

Under present law, neither ERISA nor the Code treats a qualified domestic relations order as a prohibited assignment or alienation of benefits under a pension plan. In addition, the Act creates an exception to the ERISA preemption provision only with respect to these orders.

A "qualified domestic relations order" is a domestic relations order that (1) creates or recognizes the existence of an alternate payee's right to, or assigns to an alternate payee the right to receive all or a portion of the benefits payable with respect to a participant under a pension plan, and (2) meets certain other requirements. A domestic relations order is any judgment, decree, or order (including approval of a property settlement agreement) that relates to the provision of child support, alimony payments, or marital property rights to a spouse, former spouse, child, or other dependent of the participant, and is made pursuant to a State domestic relations law (including community property law).

An alternate payee includes any spouse, former spouse, child, or other dependent of a participant who is recognized by a qualified domestic relations order as having a right to receive all, or a portion of, the benefits payable under a plan with respect to the participant.

The qualified domestic relations order provisions do not prevent the payment of amounts in pay status with respect to an alternate payee to a State agency that is an agent of an alternate payee or the payment of such amounts if the alternate payee consents to such payment (for example, to meet the requirements relating to Aid to Families with Dependent Children). In such a case, payment to the agency does not result in disqualification of the order and, under normal principles of constructive receipt, the alternate payee is treated as having received the amounts paid under the order.

1. Tax treatment of divorce distributions

Present Law

Special rules are provided for determining the tax treatment of benefits subject to a qualified domestic relations order. For purposes of determining the taxability of benefits, the alternate payee is treated as a distributee with respect to payments received from or under a plan.

In addition, net employee contributions (together with other amounts treated as the participant's investment in the contract) are apportioned between the participant and the alternate payee under regulations prescribed by the Secretary of the Treasury.

Explanation of Provision

The bill provides that the special rules for determining the taxability of benefits subject to a qualified domestic relations order apply only to distributions made to an alternate payee who is the spouse or the former spouse of the participant. Thus, distributions to a spouse or former spouse generally will be included in the gross

income of the spouse or former spouse. Under the bill, however, a distribution to an alternate payee other than a spouse (e.g., a child) is generally to be includible in the gross income of the participant. (For purposes of lump sum treatment, amounts paid to an alternate payee other than a spouse, or former spouse, shall be treated as part of the balance to the credit of the participant).

In addition, under the bill, the rules for allocating an employee's investment in the contract between the employee and an alternate payee apply only if the alternate payee is a spouse or former spouse of the participant.

If the alternate payee is not a spouse or former spouse, then the investment in the contract is not allocated to the alternate payee and is recovered by the participant under the general basis recovery rules applicable to the participant.

2. Determination by plan administrator

Present Law

To be a qualified order, a domestic relations order must clearly specify (1) the name and last known mailing address (if available) of the participant and the name and mailing address of each alternate payee to which the order relates, (2) the amount or percentage of the participant's benefits to be paid to an alternate payee or the manner in which the amount is to be determined, and (3) the number of payments or period for which payments are required. Subsequent vesting or benefit accruals of a participant are not taken into account in determining the amount payable to an alternate payee unless specifically provided under the domestic relations order.

A domestic relations order is not a qualified order if it (1) requires a plan to provide any type or form of benefit, or any option, not otherwise provided under the plan, (2) requires the plan to provide increased benefits, or (3) requires payment of benefits to an alternate payee that are required to be paid to another alternate payee under a previously existing qualified domestic relations order.

The administrator of a plan that receives a domestic relations order is required to notify promptly the participant and any other alternate payee of receipt of the order and the plan's procedures for determining whether the order is qualified. In addition, within a reasonable period after receipt of the order, the plan administrator is to determine whether the order is qualified and notify the participant and alternate payee of the determination.

During any period in which the issue of whether an order is a qualified order is being determined (by the plan administrator, by a court of competent jurisdiction, or otherwise), the plan administrator is to defer the payment of any benefits in dispute. These deferred benefits are segregated either in a separate account in the plan or in an escrow account. A plan administrator similarly could not permit a loan to be made to the participant during the period of deferral if the loan is to be secured by the benefits in dispute.

If the order is determined to be a qualified domestic relations order within 18 months after benefits are first deferred, then the plan administrator is to pay the segregated amounts to the persons

entitled to receive them. If the plan administrator determines that the order is not a qualified order or, after the 18-month period has expired, the plan administrator has not resolved the issue of whether the order is qualified, the segregated amounts are paid to the person or persons who would have received the amounts if the order had not been issued.

Explanation of Provision

The committee intends that an order will not fail to be a qualified domestic relations order even if the form of the benefit does not continue to be a form permitted under the plan on account of (1) a plan amendment or (2) a change of law. In the case of a plan amendment, an alternate payee remains entitled to receive benefits in the form specified in the order unless the alternate payee elects to receive benefits in another form and the election of such alternate form does not affect, in any way, the amount or form of benefits payable to the participant. In the case of a change of law, which makes the form specified in the order impermissible, the committee intends that the plan is to permit the alternate payee to select a form of benefit specified in the plan, provided the selection of an alternative form by the alternate payee does not affect, in any way, the amount or form of benefits payable to the participant.

The bill makes it clear that the 18-month period during which benefits may be deferred begins with the date on which any payments would, but for the deferral, be required to commence. Accordingly, if a payment is deferred pending the resolution of a dispute, then that payment and each other payment that is deferred within the next 18 months because of the dispute are to be segregated. If the dispute is not resolved within 18 months after the first payment is deferred, then all payments deferred during the 18-month period with respect to the dispute are to be paid to the persons who would have received them if the order had not been issued.

If a plan administrator determines that a domestic relations order is defective before the expiration of the 18-month suspension period, the committee intends that the plan administrator may delay payment of a participant's benefit until the expiration of the 18-month period if the plan administrator has notice that the parties are attempting to rectify any deficiencies in the order.

Notice of issuance of a stay during the time an appeal is pending is deemed to be notice that the parties are attempting to cure deficiencies in a domestic relations order. Further, the committee intends that a plan administrator will honor a restraining order prohibiting the disposition of a participant's benefits pending resolution of a dispute with respect to a domestic relations order.

In addition, the bill eliminates the requirement that a defined benefit plan establish an escrow account for amounts that would have otherwise been paid during the 18-month period. Instead, the plan administrator is required only to account separately for such amounts. If the deficiency is not cured or the dispute not resolved within the 18-month period, all payments deferred during the 18-month period are to be paid to the persons who would have received them if the stay or order had not been issued.

3. Form of benefit

Present Law

Under present law, a qualified domestic relations order may not require that payments to an alternate payee be made, prior to the date that the participant separates from service, in the form of a joint and survivor annuity with respect to the alternate payee and his or her subsequent spouse. Present law is not clear as to whether a plan that offers a joint and survivor annuity option may be required by a qualified domestic relations order to make payments subsequent to a participant's separation from service in the form of a joint and survivor annuity with respect to the alternate payee and his or her subsequent spouse.

Explanation of Provision

The bill clarifies that a qualified domestic relations order may not require that payments prior to, or subsequent to, a participant's separation from service be made in the form of a qualified joint and survivor annuity with respect to the alternate payee and his or her subsequent spouse.

4. Application of domestic relations provisions to plans not subject to assignment or alienation restrictions

Present Law

Under present law, it is unclear whether the rules relating to qualified domestic relations orders apply to plans, such as governmental plans (within the meaning of sec. 414(d) of the Code) that are not subject to the assignment or alienation restrictions of ERISA and the Code.

Explanation of Provision

The bill clarifies that the qualified domestic relations provisions do not apply to any plan to which the assignment or alienation restrictions do not apply. For example, a domestic relations order relating to the division of pension benefits of a participant in a plan maintained by a governmental employer is not required to meet the rules relating to qualified domestic relations orders because the payment of benefits to a spouse or former spouse of the participant is not a prohibited assignment or alienation of the participant's benefits.

5. Coordination of domestic relations provisions with Federal garnishment restrictions

Present Law

Under present law, it is unclear whether the payment of benefits pursuant to a qualified domestic relations order constitutes a garnishment for purposes of Federal or State law restrictions on garnishment of wages.

Explanation of Provision

The bill clarifies that the payment of benefits pursuant to a qualified domestic relations order is not treated as a garnishment of wages for purposes of Federal or State law restrictions on garnishment.

6. Coordination with qualified plan requirements

Present Law

A plan is not treated as failing to satisfy the requirements of section 401(a) or 401(k) of the Internal Revenue Code that prohibit payment of benefits subsequent to the participant's attainment of the earliest retirement age under the plan, but prior to termination of employment or such time as distributions are otherwise permitted solely because the plan makes payments to the alternate payee in accordance with a qualified domestic relations order. However, it is unclear whether payments made to an alternate payee pursuant to a qualified domestic relations order prior to the date at which the participant would have attained the earliest retirement age would violate these qualification requirements.

Explanation of Provision

The bill makes it clear that a plan is not treated as failing to satisfy the qualification requirements of section 401 (a) or (k) or section 409(d) of the Internal Revenue Code (prohibiting payment of benefits prior to termination of employment or such time as distributions are otherwise permitted) solely because the plan makes payment to the alternate payee, even if the payments are made with respect to a participant who has not separated from service, and they commence before the participant has attained the earliest retirement age under the plan. This exception applies, however, only if the present value of the benefit to be paid to an alternate payee (1) does not exceed $3,500 or (2) exceeds at least $3,500 and the alternate payee consents in writing to such earlier distribution. Further, the exception applies only if the distribution, if paid to the participant, would not contravene the provisions of the plan (except as permitted under section 414(p)(4)). Of course, a plan could not make distributions to an alternate payee at a time not specified in a qualified domestic relations order unless (1) the order also provided for such earlier distributions pursuant to an agreement between the plan and an alternate payee, and (2) the plan authorized such distributions.

In determining whether the present value of the benefit payable to the alternate payee exceeds $3,500, the present value of the participant's accrued benefit or that of any other alternate payee (after reduction for the benefits payable to the alternate payee) is disregarded. Similarly, for purposes of determining whether the present value of a benefit payable to a participant exceeds $3,500, the present value of amounts payable to an alternate payee under a qualified domestic relations order is disregarded.

The bill provides that, to the extent provided in a qualified domestic relations order, a spouse of a participant is not treated as a spouse. For example, a qualified domestic relations order could pro-

vide for the division of a participant's accrued benefits under a pension plan as part of a separation agreement and could further provide that the participant's spouse is not entitled to receive any survivor benefits under the usual survivor benefits provisions. Thus, the plan administrator would not be required to secure spousal consent to the participant's election to waive a survivor benefit.

In addition, the bill authorizes the Secretary of the Treasury to issue such regulations as may be necessary to otherwise coordinate the Code provisions affecting qualified domestic relations orders (sections 401(a)(13)(B) and 414(p)), and the regulations issued by the Secretary of Labor thereunder with other Code provisions affecting qualified plans. The Secretary of Labor has authority to issue regulations under the qualified domestic relations order provisions of ERISA, and the Code (secs. 401(a)(13)(B) and 414(p)), and the bill does not affect the authority of the Secretary of Labor to prescribe such regulations.

7. Earliest retirement age

Present Law

Under present law, a domestic relations order is not a qualified domestic relations order if such order requires a plan to provide any type or form of benefit, or any option, not otherwise provided under the plan. As an exception to the rule, present law provides that a qualified domestic relations order may require that an alternate payee commence receiving payments on or after the date that the participant attains the earliest retirement age under the plan, even if the participant has not yet separated from service. For purposes of the qualified domestic relations order provisions earliest retirement age under a defined contribution plan is defined as the date that is 10 years before the participant's normal retirement age. "Earliest retirement age" under a defined benefit plan is defined in the same manner as the term is defined for purposes of the survivor benefit requirements of section 417. The term "earliest retirement age" is defined for purposes of the survivor benefit provisions as the earliest date on which, under the plan, the participant could elect to receive retirement benefits.

Explanation of Provision

The bill clarifies that for purposes of the rules relating to qualified domestic relations orders a participant's earliest retirement age under a defined plan, as well as a defined contribution plan, is the date that is 10 years before the participant's normal retirement age.

Under a special exception to the rule, in the case of a plan from which a participant may make withdrawals without separating from service, the participant's earliest retirement age with respect to those amounts is the earliest date upon which the participant could elect to withdraw those amounts.

D. Cash Out of Certain Accrued Benefits (sec. 1897(d) of the bill, secs. 411(a)(11) and 417 of the Code)

Present Law

Under section 411(a)(11) of the Code, in the case of an employee who separates from service, a pension, profit sharing, or stock bonus plan may not immediately distribute the participant's benefit without the participant's consent, if the present value of the participant's accrued benefit exceeds $3,500. The interest rate used in determining whether the present value of a benefit exceeds $3,500 may not exceed the interest rate that would be used (as of the date of the distribution) by the Pension Benefit Guaranty Corporation (PBGC) for purposes of determining the present value of a lump sum distribution upon termination of the plan. The PBGC rate in effect at the beginning of a plan year may be used throughout the plan year if the plan so provides.

With respect to those plans subject to the automatic survivor benefit requirements, if the present value of the benefit under either the qualified joint and survivor annuity or the qualified preretirement survivor annuity exceeds $3,500, then the consent of the participant and spouse (or the surviving spouse if the participant has died) must be obtained before the plan can immediately distribute any part of the present value in a form other than a qualified joint and survivor annuity or a qualified preretirement annuity. The interest rate used may not exceed the interest rate that would be used (as of the date of the distribution) by the PBGC for purposes of determining the present value of a lump sum distribution on plan termination.

For purposes of both the "cash-out" provisions of section 411(a)(11) and the survivor benefit requirements (sec. 417), an accrued benefit is immediately distributable if any part of the benefit may be distributed to the participant before the later of normal retirement age or age 62.

Explanation of Provision

The bill clarifies that, for purposes determining whether a participant's benefit exceeds $3,500, the nonvested portion of the participant's accrued benefit is to be disregarded.

The bill would also permit the distribution from an employee stock ownership plan (ESOP) of dividends that are deductible by the employer under section 404(k), without the consent of the participant, or the participant and the participant's spouse even where the present value of the participant's benefit exceeds $3,500.

E. Notice of Rollover Treatment (sec. 1897(e) of the bill and secs. 402 and 6652 of the Code)

Present Law

When the administrator of a qualified plan makes a qualifying rollover distribution, the administrator is to provide notice to the recipient that (1) the distribution will not be taxed currently to the extent transferred to another qualified plan or an IRA, and (2) the

transfer must be made within 60 days of receipt in order to qualify for this tax-free rollover treatment.

Failure of the plan administrator to give the required notice of rollover treatment results in imposition of a $10 penalty for each failure (up to $5,000) for each calendar year. This penalty does not apply if the failure is shown to be due to reasonable cause and not to willful neglect.

Explanation of Provision

The bill makes it clear that a plan administrator is to provide notice when making any distribution eligible for rollover treatment. Thus, for example, notice is to be provided when a distribution eligible for rollover treatment pursuant to the partial rollover rules is made.

F. Reduction of Accrued Benefits (sec. 1897(f) of the bill and sec. 411(d)(6) of the Code)

Present Law

Under present law, a qualified plan generally may not be amended in a manner that decreases the benefits of a participant accrued prior to the amendment. An amendment is treated as reducing accrued benefits if, with respect to benefits accrued before the amendment is adopted, the amendment has the effect of either (1) eliminating or reducing an early retirement benefit or a retirement-type subsidy, or (2) except as provided by Treasury regulations, eliminating an optional form of benefit.

The bill provides that an ESOP will not be treated as violating the rule preventing reductions in accrued benefits merely because the plan sponsor eliminates or retains the discretion to eliminate a lump sum option or an installment payout option with respect to a nondiscriminatory class of employees. Similarly, an employer could retain discretion to limit the option of the plan participants to elect a stock distribution in cases in which the employer becomes substantially employee-owned, or the plan ceases to be an ESOP or a stock bonus plan. In addition, an employer would be permitted to eliminate a required cash distribution option in cases in which the employer securities become readily tradable or to require a cash distribution in cases in which stock in the plan is sold in connection with a sale of substantially all of the company.

An ESOP sponsor is permitted the flexibility to amend the plan to change distribution and payment options under the plan provided any such amendments are within the permissible parameters of the distribution and payment requirements of present law.

G. Transitional Rules (sec. 1897(h) of the bill and sec. 303 of the Act)

Present Law

The qualified joint and survivor annuity and qualified preretirement survivor annuity provisions added by the Act generally are effective for plan years beginning after December 31, 1984.

The new rules for qualified joint and survivor benefits and preretirement survivor benefits apply to any participant who performs at least one hour of service or has at least one hour of paid leave under the plan on or after the date of enactment. In addition, a qualified preretirement survivor annuity must be provided (unless another form of benefit is elected) in the case of any participant who (1) performs at least one hour of service or has at least one hour of paid leave under the plan on or after August 23, 1984, (2) dies before the annuity starting date, and (3) dies before the first day of the first plan year to which the provisions apply.

The Act immediately imposes certain survivor benefit requirements with respect to participants who die before the plan is required to be amended to comply with the Act. During this transition period, it appears that a plan is required to make payments to a surviving spouse notwithstanding the possible contractual claims of other designated beneficiaries. However, although the Act was not intended to impose liabilities on pension plans in excess of a participant's accrued benefits or in excess of the survivor benefits required to be provided to surviving spouses, it is unclear whether the survivor benefits required by the Act reduce the total death benefits payable to other designated beneficiaries.

Explanation of Provision

The bill clarifies the application of the transitional rule relating to qualified preretirement survivor benefits in situations in which the participant had designated a beneficiary other than the participant's spouse. Under the bill, the present value of a death benefit payable to any beneficiary with respect to an individual who (1) performs at least one hour of service under the plan on or after August 23, 1984, (2) dies before the annuity starting date, and (3) dies before the effective date of the Act, may be reduced by the present value of the amount payable to the participant's surviving spouse pursuant to the transition rule. If death benefits payable under a plan are divided among more than one beneficiary, the present value of the amount payable to each beneficiary (including benefits, other than survivor benefits payable under the transition rules, payable to the surviving spouse) is reduced proportionately by the amount payable to the surviving spouse pursuant to the transition rule.

However, the bill also permits the surviving spouse to waive the right to receive the qualified preretirement survivor annuity. Under the bill, if it is made on or before the close of the second plan year to which the Act applies, then the waiver is not to be treated as a taxable transfer for purposes of the gift tax or as a prohibited assignment or alienation for purposes of ERISA or the Code. In addition, death benefits waived by the surviving spouse during this period would not be includible in the spouse's income. Such benefits would be includible in the gross income of the recipient.

Finally, the bill clarifies that in the case of a plan that was amended, as of the effective date of REA, to be exempt from the REA survivor benefit requirements, but that (1) was not technically exempt from the survivor benefit requirements during the transi-

tion rule period and that (2) failed to satisfy the REA transition rules solely because with respect to a participant who died during the transition period, the plan paid to the surviving spouse the participant's entire vested account balance in a form other than a life annuity, the plan will not be treated as failing to satisfy the survivor benefit requirements of REA.

H. Effective Date for Collectively Bargained Plans (sec. 1897(c)) of the bill and sec. 303(b) of the Retirement Equity Act)

Present Law

The provisions of the Retirement Equity Act of 1984, were generally effective for plan years beginning after December 31, 1984. In the case of a plan maintained pursuant to one or more collective bargaining agreements ratified by the date of enactment between employee representatives and one or more employers, the provisions are generally effective for plan years beginning after the earlier of (1) the date upon which the last of the collective bargaining agreements relating to the plan terminates (determined without regard to any extension agreed to after the date of enactment), or (2) January 1, 1987.

The spousal consent provision of REA is effective for elections (or revocations of elections) made on or after January 1, 1985, with no special effective date for collectively bargained plans. Similarly, the provisions of REA relating to assignments in divorce and separation proceedings generally apply on January 1, 1985, with no special effective date for collectively bargained plans. The provision of REA relating to cutbacks of a participant's accrued benefit is effective July 30, 1984, with a special effective date of April 1, 1985, for plans maintained pursuant to collective bargaining agreements that are successor agreements to one or more collective bargaining agreements that terminated after July 30, 1984, and before January 1, 1985.

Explanation of Provision

The bill would amend REA to provide that, in the case of a plan maintained pursuant to one or more collective bargaining agreements, the provisions of REA are generally effective for plan years beginning after the earlier of (1) the date upon which the last of the collective bargaining agreements relating to the plan terminates (determined without regard to any extension agreed to after the date of enactment), or (2) July 1, 1988.

The amendment does not alter the effective date of the spousal consent provision of REA, the provisions of REA relating to qualified domestic relations orders, or the provision of REA relating to the cutback of a participant's accrued benefit.

TECHNICAL CORRECTIONS TO THE CONSOLIDATED OMNIBUS BUDGET RECONCILIATION ACT OF 1985

Technical Corrections to Customs User Fees

1. Amendment Relating to Fee on Passengers (sec. 1893(a) of the bill and sec. 13031(b) of the Consolidated Omnibus Budget Reconciliation Act of 1985)

The bill clarifies that the $5 fee for passengers arriving in the United States shall not be collected from passengers in transit to a destination outside the United States where the passenger does not pass through Customs inspectional services.

2. Amendment Relating to Overtime Provided by U.S. Customs at Foreign Preclearance Facilities (sec. 1893(b) of the bill and sec. 13031(e)(1) of the Consolidated Omnibus Budget Reconciliation Act of 1985)

The bill clarifies that overtime customs services are to be provided at no cost to airlines or airline passengers in connectrion with the pre-clearance of scheduled airline flights where pre-clearance takes the place of Customs inspection upon the arrival of such airline flights in the United States.

3. Amendment Relating to Remittance of Fees (sec. 1893(c) of the bill and sec. 13031(g) of the Consolidated Omnibus Budget Reconciliation Act of 1985)

The bill specifies that Customs user fees are to be collected and remitted to the Customs Service through procedures comparable to those already in place for the collection and remittance to the Internal Revenue Service of the tax on the use of international travel facilities.

4. Amendment Relating to Overtime Charges for Inspectional Services Other Than Those Performed for Customs Purposes (sec. 1893(d) of the bill, sec. 13031(h)(2) of the Consolidated Omnibus Budget Reconciliation Act of 1985, and sec. 53 of the Airport and Airway Development Act of 1970)

The bill clarifies that overtime charges incurred for inspectional services of the Federal Government, other than Customs, such as for agricultural and immigration inspections, are not affected by the changes made by the Customs user fee provision. Such overtime services are to be reimbursed on the same basis as was the case prior to the enactment of section 13031 of the Consolidated Omnibus Budget Reconciliation Act of 1985.

B. Medicare and Medicaid Technical Corrections (sec. 1895 of the bill, secs. 1866, 1842, 1902, 1903, and 1920 of the Social Security Act, and secs. 9127, 9202, 9221, 9517, and 9528 of the Consolidated Omnibus Budget Reconciliation Act of 1985)

The bill makes miscellaneous technical corrections to the Social Security Act and the Consolidated Omnibus Budget Reconciliation Act of 1985 (P.L. 99-272). The corrections will be effective as if the corrected provisions had been originally included in, or amended by, P.L. 99-272.

C. Extension of Time for Filing Credit or Refund With Respect to the Minimum Tax (sec. 1896 of the bill)

Present Law

The Act provided that certain transfers by insolvent farmers did not give rise to a minimum tax preference. This provision was effective for taxable years beginning after December 31, 1981.

Explanation of Provision

The bill provides that a claim for refund or credit resulting from the amendment made by the Act may be filed within one year after the date of enactment of this bill.

V. COSTS OF CARRYING OUT THE BILL AND VOTE OF THE COMMITTEE

A. Budget Effects

In compliance with paragraph 11(a) of Rule XXVI of the Standing Rules of the Senate, the following statement is made relative to the estimated budget effect of H.R. 3838, as amended by the committee.

Revenue Effects

The table below summarizes the estimates of the net changes in budget receipts from the tax provisions for fiscal years 1986–1991. The bill, as amended, is estimated to reduce tax revenues by $952 million over the fiscal year 1986–1991 period. The estimates are presented in greater detail in Part III of this Report ("Budget Effects of the Bill").

SUMMARY REVENUE EFFECTS OF H.R. 3838, AS AMENDED

[Fiscal years; in millions of dollars]

Type of tax	1986	1987	1988	1989	1990	1991
Individual	815	561	−35,636	−33,750	−17,712	−14,285
Corporate	6,580	23,066	15,214	12,776	17,300	25,448
Employment		−706	−356	−203	−115	−243
Excise		−6	62	109	116	124
Estate and gift		−101	−22	4	4	4
Customs duties		(1)	(1)	(1)	(1)	(1)
Total revenue	7,395	22,814	−20,738	−21,064	−407	11,048

[1] Less than $5 million per year.
[2] Negligible.

Outlay effects

The following provisions of the bill as amended are estimated to increase budget outlays:

[Fiscal years; in millions of dollars]

Provision	1986	1987	1988	1989	1990	1991
Earned income credit (refundable amount		50	1,376	3,155	3,505	3,846
Interest payments by IRS		(1)	(1)	(1)	(1)	(1)
Attorney's fees		(1)	(1)	(1)	(1)	(1)
Tax Court provisions		(2)	(2)	(2)	(2)	(2)
Tax Administration Trust Fund		465	765	1,030	1,055	1,010

[1] Less than $5 million per year.
[2] Negligible.

B. Vote of the Committee

In compliance with paragraph 7(c) of rule XXVI of the standing rules of the Senate, the following statement is made relative to the vote by the committee on the motion to report the bill as amended. H.R. 3838, as amended by the committee, was ordered favorably reported by a roll call vote of 20 ayes ands 0 nays.

VI. REGULATORY IMPACT AND OTHER MATTERS TO BE DISCUSSED UNDER SENATE RULES

A. Regulatory Impact

Pursuant to paragraph 11(b) of Rule XXVI of the Standing Rules of the Senate, the committee makes the following statement concerning the regulatory impact that might be incurred in carrying out H.R. 3838 as amended by the committee.

Numbers of individuals and businesses who would be regulated

The bill modifies existing tax provisions of the Internal Revenue Code in ways to facilitate compliance with the Federal income tax laws and reduces the number of individuals required to file tax returns.

Economic impact of regulation on individuals, consumers and business

The provisions are not intended to have a regulatory impact on substantive economic activities of individuals, consumers or businesses, other than through the provisions that are designed to improve the administration of, and compliance with, Federal income tax laws.

Many provisions of the bill as amended will reduce the opportunities to avoid taxation and to fail to comply with the tax laws. Other provisions decrease the tax benefits available through various credits and deductions. The net effect of the changes will be to decrease the role of the Government and to increase the role of private capital markets in determining the allocation of investment funds among business activities.

Impact on personal privacy

The provisions generally do not relate to the personal privacy of individuals. The bill does provide for the exchange of tax information with certain large cities.

Determination of the amount of paperwork

Any change in the amount of paperwork that taxpayers may have to do is related to their financial status and the nature of their investments, which afffects the complexity of their tax returns as well as the comparative difficulty of their compliance with the provisions in the Internal Revenue Code. The bill as amended will remove more than 6 million individual taxpayers from the Federal tax rolls, which will reduce the paperwork burden on those individuals.

The increase in the standard deduction will significantly reduce the number of individual taxpayers that itemize deductions on their tax returns, which will simplify their tax compliance and the

IRS administration of such tax returns. Likewise, the elimination of the sales tax itemized deduction, the increased floor under certain employee business medical expense deductions, the disallowance of the deduction for miscellaneous expenses, the 1-percent floor under certain employee business expense deductions, and the repeal of income averaging will further simplify individual tax return preparation and IRS administration. Fewer taxpayers will need to have outside assistance with preparation of their tax returns.

The compliance provisions will result in improved administration of the tax laws and greater efficiency in collecting correct tax liabilities.

B. Other Matters

Consultation with Congressional Budget Office

In accordance with section 403 of the Budget Act, the committee advises that the Director of the Congressional Budget Office has examined the revenue and outlay estimates (shown in Part III of this Report), and submitted the following statement with respect to the budget effects of H.R. 3838 as amended by the committee.

U.S. CONGRESS,
CONGRESSIONAL BUDGET OFFICE,
Washington, DC, May 29, 1986.

Hon. BOB PACKWOOD,
Chairman, Committee on Finance, U.S. Senate, Washington, DC.

DEAR MR. CHAIRMAN: In accordance with Section 403 of the Congressional Budget Act as amended, the Congressional Budget Office has reviewed the Tax Reform Act of 1985, H.R. 3838, as ordered reported by the Senate Committee on Finance with an amendment in the nature of a substitute. CBO concurs with the Joint Committee on Taxation (JCT) estimates of revenue effects. CBO has estimated the costs of the policy initiatives for tax compliance and administration.

Because the bill would remove the need for annual appropriations by giving the Internal Revenue Service direct spending authority via establishment of a Tax Administration Trust Fund, CBO estimates shown here include total IRS spending over the period instead of the outlay effects of the initiatives only as shown in Table III-2 prepared by the Joint Committee on Taxation. Because of this difference, the CBO estimates of outlays shown below exceed those included in Table III-2 by $20.3 billion over 1987–1991. Over the 1986–1991 period, H.R. 3838 would add $21.4 billion to the deficit relative to current law. Because this includes $18.9 billion of IRS outlays that are in the CBO baseline, the net deficit increase relative to the baseline would be $2.5 billion.

The total budgetary effects of the bill relative to current law are shown below.

[By fiscal year, in billions of dollars]

	1986	1987	1988	1989	1990	1991
Estimated budget authority [1]		4.5	6.2	8.4	8.9	9.4
Estimated outlays [1]		3.9	6.2	8.3	8.9	9.4
Estimated revenues	7.4	23.3	−18.6	−16.9	4.2	16.0
Net deficit effect	−7.4	−19.3	24.8	25.2	4.7	−6.6

[1] These estimates include total spending for IRS activities provided by this bill and represent an increase of about $5.8 billion over baseline projections for the 1987-1991 period.

SPENDING

The bill would establish, effective October 1, 1986, a Tax Administratioan Trust Fund in the Treasury of the United States for the operations of the Internal Revenue Service (IRS). The bill would appropriate to the fund all unobligated balances of amounts appropriated to the IRS through September 30, 1986, and all interest and penalties received by the IRS between September 30, 1986 and October 1, 1991 (and not otherwise dedicated to another trust fund). Under current law, the operations of the IRS are funded through annual appropriations. This bill would remove the need for annual appropriations by giving the IRS direct spending authority, limited to certain annual amounts set in the bill plus amounts that may be necessary for increases in pay and other benefits required by law. The spending limits are estimated to be sufficient to fund existing staff levels as well as some initiatives to increase certain staff and computer resources; a number of these initiatives are estimated to result in additional revenues.

Based on the spending limits established in the bill and the pay increase assumptions included in S. Con. Res. 120, the Fiscal Year 1987 Concurrent Resolution on the Budget as passed by the Senate on May 2, 1986, we estimate that outlays from the Tax Administration Trust Fund would total about $25.1 billion over the 1987-1991 period. This represents an increase of about $5.8 billion over baseline spending projections during that period, or about $1.2 billion per year. The estimated spending from the trust fund as a result of the spending authority provided in the bill is presented in the following table:

[By fiscal year, in billions of dollars]

	1987	1988	1989	1990	1991
Estimated budget authority	4.4	4.8	5.2	5.4	5.5
Estimated outlays	[1] 3.9	4.8	5.2	5.4	5.5

[1] In addition, there would be an estimated $0.4 billion in 1987 outlays from previous appropriations.

The bill also authorizes the appropriation of not more than $4 billion in repayable advances to the trust fund during fiscal year 1987, which must be repaid to the Treasury with interest before September 30, 1987. We estimate that this provision would result in no cost to the federal government.

H.R. 3838 would also change the method used to determine interest paid by the IRS on tax refunds. The bill would tie interest payments to the short-term applicable federal rate (AFR), which would be adjusted quarterly, plus two percentage points; whereas under current law, interest payments on refunds are based on a semiannual average of the prime rate. CBO estimates that this change would have a negligible effect on outlays in each year and over the five-year period.

The bill would also extend and clarify rules enacted in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) pertaining to the payment of attorneys' fees in tax cases where the taxpayer prevails and the government position is considered unreasonable. Rules enacted in TFRA applied to tax cases begun after February 28, 1983 and before January 1, 1986. The bill provides for a permanent extension of the awards of reasonable litigation costs for tax cases. CBO estimates that this provision would increase outlays by less than $5 million annually, beginning in fiscal year 1987.

H.R. 3838 would increase and restructure the earned income tax credit (EITC). Under current law, an eligible individual is allowed a refundable income tax credit (which is treated as an outlay in the federal budget) equal to 11 percent of the first $5,000 of earned income, for a maximum credit of $550. The maximum allowable credit is phased down as adjusted gross income (AGI) rises above $6,500 and is not allowed for taxpayes with AGI above $11,000. The bill increases the maximum allowable credit to 14 percent of the first $5,000 of earned income, phases the credit out for AGI between $10,000 and $17,000 and adjusts the maximum amount of the credit and the phaseout income levels for inflation. The estimated increase in spending, as a result of this provision, is shown below:

[By fiscal year, in billions of dollars]

	1987	1988	1989	1990	1991
Estimated budget authority	0.1	1.4	3.2	3.5	3.8
Estimated outlays	0.1	1.4	3.2	3.5	3.8

STATE AND LOCAL IMPACT

CBO is unable at this time to estimate the effect of the bill on state and local governments.

With best wishes,

Sincerely,

RUDOLPH G. PENNER, *Director.*

New Budget Authority

In compliance with section 308(a)(1) of the Budget Act, the committee states that the bill as amended involves increased fiscal year budget authority (with respect to the increase in the refundable earned income credit—treated as a budget outlay) of $50 million in 1987, $1,376 million in 1988, $3,155 million in 1989, $3,505 million in 1990, and $3,846 million in 1991. The bill as amended involves budget outlays of less than $5 million per year for the attor-

ney's fees provision and certain Tax Court provisions. Also, the bill as amended involves outlays for IRS interest on tax overpayments of less than $5 million per year.

The Tax Administration Trust Fund involves fiscal year budget authority of $4,340 million for 1987, $4,655 million for 1988, $4,930 million for 1989, $4,985 million for 1990, and $5,040 million for 1991.

There is also an authorization for the appropriaiton of funds for administrative purposes for the targeted jobs tax credit program.

Tax Expenditures

In compliance with section 308(a)(2) of the Budget Act, the committee makes the following statement with respect to tax expenditures.

The bill as amended will involve a net decrease in tax expenditures (individual and corporate income tax provisions) for fiscal years 1986–1991, of *$423* billion, as follows:

NET CHANGE IN TAX EXPENDITURES

[Fiscal years; billions of dollars]

	1986	1987	1988	1989	1990	1991
Individual income tax	0.7	14.3	44.3	43.0	50.3	55.3
Corporate income tax	5.9	31.0	36.1	40.6	46.8	56.0
Net changes in tax expenditures [1]	6.6	44.3	80.4	83.6	97.1	111.3

[1] These estimates are based on the new tax rate schedules for individuals and corporations under the bill as amended. Changes in the basic tax rate structure (individual tax rates, personal exemptions, and standard deduction, and basic corporate tax rate) are not considered as affecting tax expenditures. The graduated tax rate for small corporations is counted as a tax expenditure. Changes in excise and estate and gift taxes are not considered to involve tax expenditures under the current definition of tax expenditures.

VII. CHANGES IN EXISTING LAW MADE BY THE BILL

In the opinion of the committee, it is necessary in order to expedite the business of the Senate, to dispense with the requirements of paragraph 12 of Rule XXVI of the Standing Rules of the Senate (relating to the showing of changes in existing law made by the provisions of H.R. 3838, as reported by the committee).

VIII. ADDITIONAL VIEWS OF SEN. WILLIAM L. ARMSTRONG

On Tax Reform

Well, cynics were wrong!

Against all the odds, the Senate Finance Committee has produced a tax reform proposal which incorporates drastic rate reduction, simplification and loophole closing.

What is even more remarkable, the Committee's bill preserves deductions for charity, most state and local taxes and mortgage interest . . . the most cherished tax deductions of Middle America.

Under the circumstances, it is no wonder that Chairman Bob Packwood is being lionized from coast-to-coast for his daring and resourceful leadership. All of us who have been longing for tax reform owe Senator Packwood and those who helped him a large debt of gratitude.

Along with every member of the Committee, I voted to recommend the bill to the Senate. And I did so with enthusiasm, being fully prepared to vote for final passage of the bill in its present form. As it now stands, this bill is a vast improvement over present law and a much fairer, sounder, more interesting proposal by far than Treasury I, Treasury II or the bill sent over by the House.

But . . .

It is far from perfect. Without laboring the points now, I note several serious flaws in this legislation:

1. The passive investment rule: During floor consideration of this measure, I intend to point out the injustice of the bill which will prevent persons who have losses in passive investments from netting these losses against taxable income from similar source. I will also ask my colleagues to consider the serious adverse impact this provision will have on some segments of the real estate and energy industries, among others, and the probable consequences for all start-up industries.

2. The minimum tax: Revisions are needed in the minimum tax proposal to avoid subjecting firms which are breaking even or losing money from being forced to pay taxes on "paper" profits. This will be especially hurtful to certain so-called "smokestack" industries . . . precisely those which are fighting for existence against tough foreign competition.

3. Builder Bonds: I believe the committee's proposal should take a more moderate approach toward the use of bond financing of new home construction.

4. Business entertainment expense: I think the Committee went off the deep end by disallowing a portion of business entertainment expense. Such a decision is both illogical and unfair in my opinion. More to the point, perhaps, the result will be the loss of $32 billion

in restaurant and related sales in the next two years and a corresponding loss of jobs for food service industry employees.

If full deductibility is not restored, this provision will become a precedent for disallowing a portion of other legitimate business expenses such as legal expenses, advertising, transportation, etc. . . . paving the way for the worst kind of government meddling in private business decisions.

5. Capital Gains: The lag between rate reduction and capital gain phase out will create a notch which ought to be corrected both for fairness and to avoid market distortions as investors seek to sell out prior to the end of favorable capital gains rates.

In addition, it would be wise to index the basis of capital gains so as to avoid taxing artificial gains arising from inflation.

6. Sales Tax: The committee permits continued deductibility of most state and local taxes. Under the circumstances the decision not to allow federal income taxpayers to deduct local sales taxes seems doubly perverse.

Despite such concerns, the bill remains a remarkably popular and desirable blueprint for tax reform. I am pleased to support it with the hope of perfecting amendments . . . now or at some appropriate later time.

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